The New York Certified Public Accountant

VOL. XVIII *December · 1948* No. 12

Society and Editorial Offices: 677 Fifth Avenue, New York 22, N. Y.

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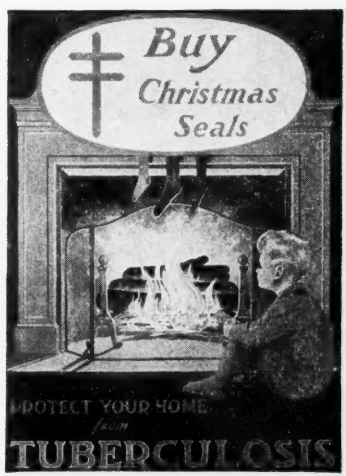

THE NEW YORK
CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

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VOL. XVIII — *December • 1948* — NO. 12

Preservation of Accountants' Records

By GEORGE N. FARRAND, C.P.A.

THIS paper deals with the preservation and/or destruction of records, working papers, reports and other material belonging to and in the possession of the practicing certified public accountant. It is concerned only incidently with such material as belongs to and is in the possession of the accountant's clients.

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>
> Mr. Farrand's professional career includes service as a member of the staff of Lybrand, Ross Bros. & Montgomery, C.P.A's., Research Assistant, American Institute of Accountants, Officer, U.S.N.R., Cost Inspection Service, and Research Associate, Office of Contract Settlement. He is presently Assistant to the Secretary and Treasurer of Young and Rubicam, Inc., New York.
>
> He is also now serving as a member of the accounting faculty of the New York University Graduate School of Business Administration, and formerly lectured on Accounting at Columbia University, New York, as well as at several universities in Washington, D. C.
>
> Mr. Farrand is the author of several other articles which have heretofore appeared in *The New York Certified Public Accountant,* and other publications.

The many questions which have been asked on this subject and will be dealt with herein fall into two major categories—preservation and destruction. Under preservation, questions arise as what records and material should be preserved, for how long a period, and in what manner. In considering destruction of these items, one is concerned with the time when they should or may be destroyed and the manner in which this should be done.

The practitioner unfamiliar with this subject may regard it as highly academic and of no great concern. One with experience, however, will readily refute such allegations because there are some real, practical problems in this area. While there is no question that important material in the accountant's files should be stored in a safe, accessible place, the cost of such storage space and limitations on its extent and convenience pose difficult problems which are not always easy to solve. Ordinarily, the solution lies somewhere between the extremes of preserving all records indefinitely and destroying all records currently.

Interest in this subject has been kindled in recent years by the accumulation of extensive records relating to war production and the enactment of legislation very extensive in scope dur-

ing the war period, followed by the critical shortage of suitable storage space during the present post-war period. Evidence of this interest by practicing public accountants is found in the numerous inquiries for information on the subject made of the American Institute of Accountants and of the State Society by representatives of small as well as large firms.

In spite of the current interest in this subject, there is very little literature available which treats the specific problems of the public accountant. The matter was dealt with briefly by Harold R. Caffyn at the annual meeting of the American Institute of Accountants held in 1940[1] and by the Society's Committee on Accountant's Practice in *The New York Certified Public Accountant* of May, 1940.[2] A member of the Institute is presently preparing an extensive booklet on various aspects of public accounting practice which it is understood will include a discussion of record preservation.

Considerably more literature is available which deals with the preservation of records generally, particularly those of business concerns which would fall in the category of typical clients of accounting firms. Besides articles appearing in *The Journal of Accountancy,*[3] *The Controller,*[4] and other technical periodicals, several pamphlets have been prepared by interested organizations.[5]

Among the various governmental laws and regulations requiring retention of records, the provisions of the Contract Settlement Act of 1944[6] and regulations issued thereunder by the Office of Contract Settlement[7] are probably the most comprehensive. Section 19 of that Act provides criminal penalties for the willful destruction of "any records of a war contractor relating to the negotiation, award, performance, payment, interim financing, cancelation or other termination, or settlement of a war contract of $25,000 or more . . ." until five years after the final settlement of such war contract or five years after the termination of hostilities in World War II, whichever is longer. No knowledge has yet come to the attention of the author that the latter event has officially taken place for this purpose.

To implement the meager information available on this subject, the author conducted a limited survey among large, small, and medium-sized accounting firms to determine their current practices in the matter of retention and destruction of records and documents. Inquiry was also made of manufacturers and distributors of microphotographic equipment as to the features of this process and its various uses. The results of these inquiries were influential in formulating the recommendations which follow.

Accountants' Records

In approaching the problem of record preservation, the logical first step is to determine what records we are concerned with and to classify them in a systematic manner. The records of most public accounting firms, regard-

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1 *Experiences with Extensions of Auditing Procedure,* page 151.

2 Page 467.

3 October, 1938, page 269; September, 1944, page 263; April, 1946, page 300; and April, 1947, page 304.

4 Replies to questionnaire prepared by Committee on Technical Information and Research of the Controllers Institute of America, *The Controller,* July, 1944, page 295.

5 *Business Records Classification and Retention Recommendations,* Diebold, Incorporated; *Minimum Retainment Periods for Bank Records,* Chicago Bank Auditors Conference; *Retention and Preservation of Records,* Chicago Bureau of Filing and Indexing; *The Preservation of Business Records,* by Ralph M. Hower, The Business Historical Society, Incorporated.

6 Public Law 395, 78th Congress, 2nd Session, Section 19(a).

7 Regulations Nos. 11 and 19 of the Office of Contract Settlement, issued January 24 and July 9, 1945.

less of size, may be classified broadly into the following categories: auditing, taxes, special engagements, general correspondence, clients' records, and firm records. The types of records embraced in each of these categories are set forth in the following outline:

Auditing:
- Reports—final, copies, drafts
- Working papers—current, permanent
- Internal control—check lists, memoranda, notes, reports, correspondence
- Other correspondence

Taxes:
- Tax returns
- Working papers
- Bureau of Internal Revenue reports and correspondence
- Other correspondence

Special Engagements:
- S.E.C.—reports, working papers, correspondence, etc.
- Accounting systems — reports, working papers, correspondence, etc.
- Other engagements—fraud, sale of business, etc.

General Correspondence:
- Clients, professional, firm operations

Clients' Records:
- Books, checks, vouchers, documents, etc.

Firm Records:
- Books—ledgers, journals, cash, minutes
- Documents—checks, vouchers, bills, invoices, time records, insurance policies, leases, agreements, etc.
- Personnel — applications, compensation, reports, insurance
- Partnership—articles, agreements, contracts, accounting data

The foregoing outline is not intended to be all-inclusive, but rather as suggestive of the many different types of records and documents which are usually kept in the files of accounting firms and as a guide to the subsequent discussion. Other material which also may create a filing problem includes copies of published reports and prospectuses, technical magazines, pamphlets, bulletins, services and other library material.

Period of Retention

Having determined what records the public accountant is likely to have in his files, the next questions relate to which records should be retained, in what manner, and for how long. The period of retention of particular records is a matter for determination by each firm in the light of the circumstances prevailing. However, legal and practical considerations may be helpful guides in making this decision.

Legal Considerations

The statute of limitations applicable to the mandatory retention of particular records or to the taking of legal actions in respect of matters to which records relate, would ordinarily be the minimum retention period for such records. Unfortunately, however, a definite period for such purposes is frequently difficult, if not impossible, to obtain, because the statutes vary so greatly among the different states and for different purposes. For example, the statute of limitations governing actions under contracts in writing but not under seal is 3 years in Maryland, 5 in Virginia, 6 in New York, 8 in Montana, 10 in Illinois and 15 in Ohio.[8] Questions of situs and residence of the parties may further complicate such determination.

The statutes are more specific in respect of other matters. Actions relating to Federal income taxes ordinarily must be started within three years of the time required for filing returns, although the period is extended to five years if 25% or more of the gross income has been omitted, and it is indefinite where fraud is involved. Waivers granted by many taxpayers during the recent war period have extended further or indefinitely the period of settlement for such taxes. Records relating

[8] "The Commercial Archivist Aids the Controller," *The Journal of Accountancy*, April, 1947, page 304.

to Federal payroll and social security taxes must be retained for four years. Statutes and regulations of other regulatory bodies set forth specific periods for retention of certain or all records by the companies subject to their jurisdiction. Criminal action under the Securities Act of 1933 must be instituted within three years of the effective date of registration.

The possibility of lawsuits against an accounting firm for negligence, fraud, excessive fees or violation of the contract for services—whether brought by the client, stockholders, interested third parties, the government or the general public—should be given consideration in determining how long working papers, reports, correspondence, etc. relating to individual engagements should be retained by the firm. None of these unpleasant actions is usually contemplated during the course of an accounting engagement. Nevertheless, they are hazards of the business and their possibility must be reckoned with in determining a record retention schedule.

Practical Considerations

While legal considerations should be influential in setting minimum periods of retention of particular records and documents, practical considerations will frequently demand retention for a much longer period. Books and records kept for clients or clients' original documents in the possession of the public accountant should certainly be retained by the latter for at least as long as the client would retain them and they are best disposed of by return to the client rather than by destruction. Firm records of an accounting organization would ordinarily be retained for the same length of time as similar records are retained by other businesses, including clients.

Working papers and a copy of the report for at least the preceding year are essential in the conduct of an audit engagement as a means of establishing the opening balances of balance-sheet accounts for the year, providing reliable comparable operating data for the preceding year, setting forth the audit procedures undertaken, indicating the time required to complete various phases of the engagement, and in many other ways. An audit engagement involving a new client is expedited considerably if working papers, audit programs and reports of similar clients are available from prior years.

Information usually set forth in a so-called "permanent binder" is invaluable in the conduct of an audit of the accounts of the same client for many years. Typical information filed in such binders includes: audit program; survey of internal control; excerpts from or copies of the corporate charter, by-laws, minutes, important contracts and agreements; and running analyses of important accounts, such as fixed assets, insurance, deferred charges, reserves, long-term debt, capital stock and surplus. Frequently, such notes and analyses are better than those of the client or even the only available information of its kind. This is particularly true where the client is not very large and is heavily dependent upon the accounting firm for accounting adjustments and basic information regarding its own affairs. Although financial statements are theoretically those of the client and the accounting records should be adjusted to reflect all adjustments made by the public accountant, unfortunately, these conditions do not always hold true in practice. Accordingly, under such circumstances the accountant's working papers and related data are of invaluable importance to the client when questions arise as to past accounting matters.

Even where the client is less dependent upon the independent accountant and the books are currently adjusted to reflect audit adjustments, situations frequently arise where the accountant's papers relating to prior years are needed. Many income tax situations require data from several years past, such as the scramble during the war

years for excess profits tax data relating to invested capital and pre-war earnings, and recent retroactive application of the lifo method of determining inventories of department stores. Other instances where data for several prior years are useful are historical financial information and summary of earnings data incorporated in registration statements filed with the Securities and Exchange Commission on Form S-1 and similar forms under the Securities Act of 1933, and original cost studies by public utility companies to conform with the requirements of the uniform systems of accounts of the Federal Power Commission, National Association of Railroad and Utilities Commissioners and state regulatory bodies. When companies first incorporate earnings data for several years in their annual reports to stockholders or upon the sale or purchase of a business not subject to the S.E.C., the independent accountant's working papers may again be called upon to furnish or corroborate the data.

The foregoing illustrations indicate the desire to retain accountants' records and collateral data for as long a period as practical. However, problems of space limitations, cost of space and accessibility of records place practical limitations on any retention for an indefinite period. Accordingly, it is desirable to find a course somewhere between these two extremes whereby records are retained for specific periods of time only, depending upon their importance and the possibilities of their future use.

Suggested Periods of Retention

As previously mentioned, there are no fixed rules as to the length of time various records and documents should be retained by public accounting firms. While both legal and practical considerations may serve as guides, the decision rests ultimately with the individual firm, depending upon its own needs and desires. Regardless of its decisions, however, each firm should adopt a specific plan for record retention and designate one person, preferably a partner, to assume final responsibility for the carrying out of the plan as adopted. Such a plan should provide for the classification of all records and documents, the designation of retention periods for each type of item, and a systematic method for their filing and ultimate disposal.

On the basis of the information accumulated during the preparation of this paper, and the author's personal opinion, the following are suggested minimum periods for retention of particular types of records. Where microphotographs are to be made of records, as discussed more fully hereinafter, the original records may be destroyed much sooner although, even in such cases, it it usually desirable to retain the originals during the period of their likely use. It should be emphasized that the periods mentioned below are merely suggestive and should be altered as circumstances warrant. Also, longer periods would be justified where retention is not a serious problem:

Reports (short-form, long-form, letter):
- One copy (office)—permanent (monthly audits—5 years)
- Working copy—1 year

Working Papers:
- Audit (segregate into following 3 groups, if possible):
  - General—15 years (10 years, if no longer a client)
  - Temporary—detailed cash, receivables, inventories, confirmations, monthly audits, etc.)—5 years
  - Permanent (audit program, internal control, minutes, trial balances, contracts, analyses, etc.) — permanent
- Tax—permanent

Tax Returns:
- One copy—permanent

Securities and Exchange Commission:
- Registration statement:
  - One copy—permanent
  - Drafts (one copy of each)—3 years
- Working papers—15 years

Client's Books, etc.:

Permanent

Return to client if possible when no longer needed

Special Examinations (systems, fraud, purchase or sale of business, etc.):

Reports (one copy)—permanent

Working papers—15 years (10 years, if no longer a client)

Correspondence (segregate, if practical):

General—15 years

Tax—permanent

Routine—5 years

Firm Records (similar to other businesses):

General books (ledgers, journals, cash books, minutes, etc.)—permanent

Billing records:

Copies of bills to clients—permanent

Time reports, billing memorandums, etc.—7 years

Engagement memorandums — permanent (10 years, if no longer a client)

Personnel records—permanent (7 years, in case of applicants not hired)

Checks and general vouchers—7 years (unless for special purposes, which may be kept permanently)

Petty cash vouchers—1 year (if book record)

Check stubs—1 year (if cash book records checks also)

Leases, insurance policies, tax receipts, etc.—7 years after expiration date

Forms used (1 copy)—permanent

Partnership records (articles, agreements, private records, etc.)—permanent

Extra copies of reports, documents, correspondence, forms, etc., may be retained for convenience, but only one copy of each item need be retained for the periods mentioned above. Copies of published reports and prospectuses of companies not clients, technical books, pamphlets, library material and correspondence with technical societies may be retained for as long as is deemed practical, but there would be no required minimum periods of retention for these items.

Methods of Retention

Whether records are retained indefinitely or for limited periods, the method of their retention should be based on a definite plan. The usual rules for scientific filing should be followed. If possible, records which are used currently should be segregated from and made more accessible than older records referred to only occasionally. This is frequently accomplished by placing older records in so-called dead storage, and reserving the regular filing space for more current records. Some firms wrap up working papers after three years and place them in a less accessible filing room or the storage vaults of an outside storage concern. In such cases the papers should be properly identified on the packages and their location carefully controlled, so that they can be obtained with a minimum of effort when they are required. Whether in current files or dead storage, papers should be clearly indexed, identified as to client, nature and period of work, and stored in a reasonably safe place, free from the hazards of fire, flood, extreme temperature, theft or access by unauthorized persons. The confidential nature of most papers and other items relating to clients makes this latter precaution particularly important. Where papers have been microphotographed, as discussed later herein, the microfilms should be accorded the same care in filing and storing as would apply to the original documents from which they were made.

Methods of Destruction

When the time arrives for the destruction of an accountant's records, this too should follow an organized plan. Such time should be determined from the previously adopted schedule and all records to be destroyed should first be submitted to the person in the firm who has been designated to supervise such procedure, as previously mentioned. After reviewing the records, he should supervise their destruction and sign a statement which properly

identifies the items destroyed and indicates his approval. The precise method of destruction may vary, but whatever method is used, the items should be completely destroyed, preferably by cremation. The discarded records should not become mingled with the usual waste paper as a means of disposal, but destroyed as a separate and distinct operation. If the records are first microphotographed, the destruction will be the same as when photographs are not made.

The carrying out of a destruction program is facilitated if it is anticipated currently and the records filed in such a manner that those records which are to be destroyed will be readily available and distinguishable at the proper time. It is preferable to carry out this program on a systematic basis once each year, rather than over long periods of time or sporadically.

Microphotography

A practical solution to the accountant's record problem may be found in the use of microphotography. This process is simply the photographing of documents and development of the photograph on a film generally known as "microfilm" having a width of 16 or 35 millimeters. Its most significant feature is its very small size compared to the documents photographed. It is claimed that the contents of a 4-drawer file cabinet can be condensed into 200 feet of microfilm weighing less than 2% of the weight of the documents, or 6,060 images, 8½ x 11 inches in size, can be photographed on a single roll of 35 mm. film.

Since microphotographs save 99% of the space occupied by original documents, once photographed, the documents can be destroyed and the films retained for hundreds of years if necessary, saving much valuable storage space. Due to their peculiar properties, the films can be stored in safer and more accessible places than the bulky original records and the images will be retained in legible form for a much longer period. Furthermore, the material may be located on the film very quickly if properly indexed, and read with ease with the use of the many types of readers available. Duplicates or photographic copies of the films or particular images may also be made with dispatch from the microfilms, either in positive or negative form. The compactness of the films facilitates not only their storage and accessibility, but also their shipment to other locations for reference or storage.

The admissibility of microfilm as evidence in court has been sustained,[9] in all cases as secondary evidence and in some cases, where original documents are non-existent, as primary evidence. Certain records of the Federal government may be destroyed if microfilms thereof are retained which have been prepared in a satisfactory manner.[10] Reference has already been made to The Contract Settlement Act of 1940, which prohibits the destruction of records relating to war contracts for at least five years after the end of the war. Under the authority conferred upon him in Section 19 (a) of that Act, the Director of Contract Settlement issued Regulation No. 11 of the Office of Contract Settlement on January 24, 1945, whereby "any records to which this Regulation applies and which can be reproduced through photography without loss of their primary usefulness may be destroyed, provided, however, that clearly legible photographs thereof are made and preserved."

The Bureau of the Census, Bureau of Internal Revenue, General Accounting Office, and other Federal government agencies have made extensive use of microphotography in the copying of their own and non-governmental records for current operations and retention purposes. The use of microphotography by private industry has also

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[9] *U. S.* v. *Manton;* 107 F.(2nd) 834 (1938).

[10] Act No. 788, 76th Congress, H. R. 10026, approved September 24, 1940.

been very extensive. Banks, insurance companies, department stores, hospitals, public utilities, and newspapers have found special uses for this device in their routine operations. The "V-Mail" service which was so popular and practical during the war is another adaptation of microphotography.

Public accounting firms presently or prospectively burdened with a record retention problem would do well to consider the many advantages of microphotography. In addition to the basic benefits of space conservation, safety, accessibility, and practical permanency of legibility, microfilms of accountants' records can easily be shipped to other offices of the firm in conjunction with joint engagements or to head offices for control purposes; copies of significant schedules or documents can be prepared expeditiously for use of the firm or its clients; or such films can be projected on a screen or read with readers in staff training programs. If the firm has a camera, it can photograph schedules, trial balances or documents of clients for its own use in accounting engagements, saving valuable time otherwise spent in copying or making summaries of such material.

A few years ago one of the large public accounting firms, realizing the many advantages of microphotography and facing a space problem in connection with the storage of its voluminous working papers covering the nearly fifty years of its existence, embarked upon an ambitious program of microfilming all of its audit working papers so that the papers could thereafter be destroyed. The firm purchased a camera and engaged a full-time employee to undertake the work of arranging the papers, making the photographs and processing the finished films. The work has now proceeded to the point where all such working papers for all the firm's offices have been reduced to microfilm and the papers destroyed covering the first thirty years of the firm's existence. It is the present intention to continue the process until all but the most recent ten years of papers have been photographed; thereafter, only one year's papers will be processed each year, as they become ten years old. While audit working papers will thus be retained in original form for ten years, confirmation requests and replies, particularly in respect of brokerage and bank engagements, are photographed currently and the original documents returned to the clients. Microfilms for all papers to date occupy less than one 4-drawer file cabinet!

Another large firm is experimenting with the use of microphotography in one of its offices. It should be emphasized here, however, that the use of this method is by no means restricted to large firms who have a large volume of papers and can well afford to purchase the entire equipment and hire a full-time employee to operate it. Smaller firms need not purchase any equipment, but may utilize the services of one of the many concerns which will photograph the papers with their own equipment, either on the premises of the accounting firm or outside, develop the films and return them to the firm as seldom or often as desired. The cost of this complete service is surprisingly reasonable. If the papers are arranged in proper order by the firm, the cost may be as low as $9. per film of 3,000 images or $40 for an entire 4-drawer cabinet of papers. Readers, the equipment used to blow up the films to the original size of the documents, or projectors to project the images on a screen, can be obtained for as low as $50 or as high as $700. Equipment may be either purchased outright or rented.

Maximum benefits may be obtained from the use of microphotography by the observance of certain simple, but important rules. The material to be photographed should be arranged in an orderly, systematic manner to facilitate feeding into the camera, which may be done at a very high rate of speed, and reference to material on the microfilm at a later date. Like the papers themselves, the films should be properly in-

dexed, with a target at the beginning and end of each film indicating its contents and a statement to the effect that the original papers will subsequently be destroyed, and with supplementary indexes at the beginning of each new set of papers, such as the working papers for a given year. Obviously, a single film should preferably include only related material, such as working papers of a single client for several years or of consecutive clients on an alphabetical or similar basis for the same year. Since microfilms may not distinguish red figures clearly, consideration should be given to identifying such figures in another manner if necessary.

After it has been determined that the microphotographs have been satisfactorily taken and developed, the original records may be destroyed in the manner already mentioned. The microfilms should then be filed in a systematic manner, properly indexed, in a dry, fireproof cabinet, where the atmospheric conditions are not extreme.

There is no fixed rule as to when accountants' records should be microphotographed. This can be performed as soon as the records are available, although it may be preferable not to destroy the original records until the period of their immediate usefulness has expired. Audit working papers probably should not be destroyed earlier than three years after their preparation.

Conclusions

Apparently, many public accounting firms are today encountering difficulties in finding adequate space for the filing of their working papers, reports and other records. They are also becoming more conscious of the cost of such filing. This problem affects small firms as well as large and medium-sized ones.

The most practical approach to the solution of the record-preservation problem is to follow the following procedure: (1) classify all the records and other material involved; (2) adopt a systematic plan and schedule for the preservation and destruction of the items; and (3) appoint a responsible person in the firm to supervise the operation and approve the destruction process. Finally, careful consideration should be given to the use of microphotography as a means of putting the records in a compact form for their permanent preservation in lieu of the bulky and space-consuming original records.

Applications of Generally Accepted Accounting Principles to Cost Accounting

By Donald M. Russell, C.P.A.

Are there any principles of cost accounting that are not shared with other areas of accounting? Possibly not, if we restrict the word principles to the most fundamental ideas of accounting. I do not object, however, to a broader use of the word principles which would include a few practices, conventions, procedures, or even concepts, if by doing so we can focus attention upon those ideas about cost accounting which have general acceptance. Under this broad approach, we may find certain ideas about cost accounting that are characteristic of it and peculiar to it.

Cost Accounting Characterized by Service to Management

Accounting in any area is the art of recording, analyzing, interpreting, and reporting business transactions. What differentiates cost accounting from other accounting? It appears to me that its chief characteristic is that it is directed, as its end result, to the requirements of management. Financial accounting is concerned chiefly with the requirements of creditors, owners, the Government, prospective investors, and persons outside of the management. Generally accepted accounting principles, in other words the prevailing ideas about accounting in general, have been molded for the most part by the requirements of persons outside of the business itself. It may be fruitful to inquire as to how the characteristics of cost accounting, i.e., accounting for the use of management in connection with its responsibility to manage, differ from those of accounting directed to outside persons.

Cost accounting is not restricted to cost determination alone. Cost accounting literature and the duties of cost accountants in practice prove that cost accounting includes, in addition to tracing the flow of costs by products and services, many other matters such as studies of the extent to which costs are controllable, preparation of cost reports to aid in reducing costs and expenses, the effect upon costs of changes in the volume of production, break-even points, estimates of future costs and future profits, limits applicable to price fixing, incentive plans, studies of the desirability of replacing machine tools, etc. We shall include as cost accounting, for the purpose of this discussion, all of the accounting and statistical techniques by which cost accountants customarily serve management and, for convenience, shall refer to the accounting which enables management to report to outside persons as financial accounting. Financial accounting is concerned with many matters which are of little concern to cost accounting, viz., safeguards for cash and securities, control of col-

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lections and disbursement of funds, disclosure of equities in subsidiary enterprises, history of capital structure, income tax accounting, foreign exchange conversions, etc. The differentiation is of course not absolute; there is some overlapping, but, in general, cost accounting and financial accounting have recognizably separate areas.

It may be of interest to select certain of the generally accepted accounting principles, developed primarily from the requirements of financial accounting, and test them against cost accounting requirements. For this purpose I have selected three principles commonly recognized, as follows:

1. Accounting reports and source data must be objective and verified.
2. Accounting must be related to a specified entity.
3. Accounting, to be adequate, must trace the flow of funds.

REPORTS AND SOURCE DATA MUST BE OBJECTIVE AND VERIFIED

This idea is fundamental and has application to both financial and cost accounting. It calls for integrity in all accounting and, more than that, requires the application of intelligence to a critical search to discover facts that may be different than they appear.

Financial statements presented to the public by the management of an enterprise, have come to be recognized (after many lawsuits, the passage of laws for the protection of investors, and the development of independent auditing) as representations by the management, involving responsibilities comparable to those of a trustee. The public holds management responsible to report to it on an objective, realistic basis and it has become customary to have such reports reviewed and tested by independent public accountants in order to assure the public that the reports are objective. The source data for financial reports are for the most part capable of verification by counts of currency, independent acknowledgment of custodianship or of rights to collect monies or property, confirmation of contractual liabilities, examination of documents evidencing sales, purchases, and payrolls, independent computations of tax liabilities and accruals, and similar verification procedures. Much effort is customarily expended to assure the public that financial accounting reports are on an objective basis and that they have received an independent and critical review.

In the application of this principle in financial accounting, management and independent public accountants rely heavily upon the legal rights and responsibilities of the business enterprise. Such rights and responsibilities have often been debated in courts of law and a body of legal decisions has been built up and is available to aid in the determination of objective evidence as to the representations made in financial reports to the public. The procedures for satisfactory auditing of this evidence have been stated in the published writings of experts and have been codified in the bulletins of the American Institute of Accountants. It is true that opinion and judgment enter into such financial accounting reports. It cannot be said that all of the figures included in financial accounting are susceptible of absolute verification. The necessity for the exercise of judgment does not, however, waive the requirement of objectivity. The judgment must be fair, unbiased, and made with searching intelligence.

Varied Source Data Used In Cost Accounting

The nature of the evidence with which the cost accountant deals is more varied than in financial accounting. The source data is less formal; to some extent the cost accountant does not have the support of legal requirements in the transactions with which he deals. It is not customary, for example, to write formal contracts to clarify the relationships of departments within a

business. Opinion and judgment enter into cost accounting statements to a greater extent than in financial accounting. On the other hand, the cost accountant's public, the management of the enterprise in which he works, is usually less exacting, in a certain sense, than the general public. Management realizes that cost accounting is a cooperative activity involving all departments of the business.

Unless cost accounting reports are based upon objective evidence, subjected to critical probing as to reliability, the statements may be misleading and dangerous and they may easily lead to faulty managerial decisions and bankruptcy. Management (the principal consumer for the product of cost accounting) should be no less insistent than the general public (the principal consumer for the product of financial accounting) that the reports it receives meet the essential requirements of objectivity and verification. There should be more auditing of cost reports by both internal auditors and outside auditors. No cost reports can be more reliable than the source data. It is trite, but true, to say that many millions of dollars have been wasted by compilations of exhaustive cost reports which were of little value because of failure to verify source material.

Operating Statistics Underlie Accuracy of Cost Reports

The source data for cost accounting includes, in addition to the documents supporting dollar transactions, records of quantities or weights of materials produced, consumed, or transferred between departments, reports of time studies, records of actual and standard time by operations, bills of material and lists of operations, planning schedules, capacity studies, lists of machine tools, statistics on floor space, machine capacities, power ratings, etc. There is no inherent reason why any of these data need be any less accurate or reliable in the books of original entry of cost accounting than the dollar entries in the books of original entry of financial accounting.

Much of the source data for cost accounting originate outside of the cost accounting department. It is usually not the duty of the cost accountant to prepare or assemble this source data independently, nor should it be. It is the duty of the cost accountant, however, to insist that the principle of objective, verified source data be observed and it is the responsibility of management, in its own interest, to provide the means to ensure objectivity and verification. We have all seen or heard of instances where these important underlying statistics were no better than guesses, or having once been fairly determined, were used for years without correction for changed conditions. In small organizations, or where management does not provide independent verificaton of source data, the cost accountant should make his own tests of accuracy as he is never justified in presenting cost reports based on source data he does not believe.

Dollar Data Controlled by General Accounts

As to the dollar data used in cost accounting, they must be tied in with the controlling accounts recorded for financial accounting purposes. The responsibility for objectivity and verification of such data usually rests upon the financial accountants.

There should be maximum segregation of records for financial accounting and cost accounting. Financial accounting can and often does get along without cost accounting, though of course, management then loses a valuable tool and the financial accounting loses desirable refinements in those areas where opinion and judgment have play. Financial accounting records should be complete in themselves on a company-wide basis, receiving and using such information as cost accounting can furnish, but tracing the flow of expenses only to the extent which will be reflected in the financial reports. The

details of cost accounting should be excluded from the general ledger.

Cost accounting should pick up controlling dollar aggregates from financial accounting, subdivide them and trace them as far as it desires and close them out. Cost reduction is best controlled by study of the expenditures stated close to the first responsibility for making expenditures, and information as to expenditures at the source should not be lost by the bookkeeping processes of obtaining costs stated on the basis of benefits received. Product costs and special cost studies can best be assembled in further subsidiary records or on a working-paper basis.

So far as our first selected generally accepted accounting principle is concerned (that accounting reports and source data must be objective and verified) we note:

1. Cost accounting lacks some of the natural safeguards of financial accounting in that:
    a. It is not protected to an equal extent by the legal considerations which bind the business as a whole, and
    b. The source data is less likely to have been determined by bargaining at arm's length, and for this reason verification of source data is even more important than in financial accounting.
2. The source data is more varied and less formal than in financial accounting; it consists not only of dollar data received from the financial accountants but statistical data of great variety received from operating departments.
3. Opinion and judgment usually have more play than in financial accounting.
4. Cost reduction effort is most effective when applied close to the source of expenditures; information as to expenditures at the source should not be lost by the bookkeeping processes of obtaining costs stated on the basis of benefits received.
5. Cost accountants usually are required to use source data furnished by others but it is a responsibility of cost accountants to insist that such data be objective and verified.
6. Management should provide the means so that source data will be accurate and subjected to verification within the organization; cost reports submitted to management should be audited by internal auditors and by outside independent auditors.
7. There should be maximum segregation of records for financial accounting and cost accounting. The details of cost accounting should be excluded from the general ledger.

Accounting Must Be Related to a Specific Entity

As Professor William Morse Cole used to say, "Accounting cannot be carried on for all persons, at all places, and for all time, at once." This involves the business entity concept and the going concern concept. It is a fundamental idea of accounting that accounts are kept on an inside looking out basis wherein the entity charges and credits itself, respectively, with costs and revenues, efforts and accomplishments, or services received and services rendered. Financial accounting relates to a specified entity which usually has legal significance, a corporation, partnership, or proprietorship (a proprietorship of course may be a somewhat fictitious entity which the proprietor designates as a business separate and apart from his other affairs). There is legal or business support for the specified entity and there are legal rights and responsibilities to be observed (e. g., the right to sue and be sued and the statutory basis for determination of income taxes), all of which are applicable on a company-wide basis. The entity acts as a unit in dealing with

outside persons. Generally accepted accounting principles have been designed to deal with this kind of an entity.

Management Establishes Internal Entities

Cost accounting obviously has a different background for the development of its principles and within the scope of the company-wide boundaries it is relatively free from legal restrictions such as those which bind the company as a whole. Inside the realm the management is king. The king can and usually does establish several entities within the kingdom. These may follow distinct and natural divisions of the activities of the total enterprise, or they may cut across the departmental lines of the functional organization. The king may decree that certain inherited assets or products are to be recognized as lost, or established on a liquidation basis of accounting such that the going concern concept does not apply to them. He may decide upon entities to establish costs and measure results by processes. He may establish many separate entities requiring the measurement of profit or loss for each production contract or order as a separate venture. He may establish budgeting control with appropriations requiring accounting similar to governmental accounting. He may introduce fictitious sales from "the right-hand pocket" to "the left-hand pocket" in order to "make each activity stand on its own feet."

Thus cost accounting may introduce many business entities for purposes of management control, which are nonexistent for financial accounting. The creditors, the tax collectors and (by and large) the stockholders disregard them, wash one against the other, and make their decisions to lend, to collect tax, or to buy or sell their ownerships on the combined company-wide basis. However, the artificial entities created by management are extremely important to management and their usefulness in producing profits for the company-wide picture is real.

Are there any distinctive principles in cost accounting that stem from this difference in characteristics? There is certainly a principle of good accounting organization that it should parallel and reflect the functional organization. In order to serve management properly, the subsidiary accounting entities should follow as closely as possible the same boundaries as the responsibilities assigned by management to individuals or departments for the purpose of carrying out the operating functions. Stated differently, no person, department, or activity should be charged with controllable costs over which it has no control or for services or facilities it does not use. It has been agreed by cost accountants, based on experience, that failure to observe this principle decreases seriously the efficacy of cost reports supplied to foremen and production superintendents for purposes of cost and expense reduction.

Recommendations in Respect of Divisional Accounting

In divisional-type organizations, divisional accounting may include the accounting for divisional assets and liabilities as well as operating accounts, and the financial accounting may be modified accordingly. Where this exists it appears desirable that the accounting should be complete, even to computation of Federal income taxes on the basis of divisional income. Adjustments to the company-wide income tax liability, and financial operations so general in purpose that they have no relation to divisional operations, should be accounted for in a general division for which the president or treasurer may be responsible. Subsidiary accounting entities should be recognized for service departments as well as production departments and the top executives who hold the service department heads responsible for the success of their activity and the operating heads of the departments must alike be convinced that the accounting portrayal of the

operating activities of the service departments is complete and fair.

This generally accepted accounting principle (that accounting must be related to a specified entity) when considered in the light of cost accounting leads us to observe:

1. The cost accounting organization should be broken into such entities as will best serve management; these entities though not separate legally are real and useful for profit-making purposes.
2. The accounting entities should parallel the operating organization so that
   a. Each entity may receive a complete accounting analysis and study, and
   b. No entity shall be charged with responsibility for costs it cannot control nor with services it does not receive.

Accounting, to Be Adequate, Must Trace the Flow of Funds

Accounting may recognize only the receipt and disbursement of cash but such accounting is inadequate for the needs of either management or the public. The idea that accounting can trace the flow of funds through an enterprise (the accrual theory of accounting) is important to financial accounting and particularly important to cost accounting. In financial acccounting we give effect to this idea, in relation to balance sheet accounts, when we refer to the rapid flow of working capital from cash through the credit pool of liabilities into prepaid expenses and raw materials, work in process, finished goods, accounts receivable, and back into cash and the slower flow of funds moving into fixed assets and transferred by allowances for depreciation into work in process, finished goods, receivables, and cash.

In the income account we express the same concept by matching costs against revenues as at the dates of sale of the physical product and measuring the gross profit or loss by differences of dollar amounts received and dollar amounts previously tied on to the product which has been sold. Financial accounting has adopted the idea that selling, advertising, administrative, and general expenses cannot successfully be tied on to units of product and we therefore do not try, ordinarily, to trace them to the product, but get rid of them as soon as they are incurred or spread them only to calendar periods. In reality these expenses are incurred for the same purposes as production costs, i.e., to make and sell a product at a profit. There has not been general acceptance of accounting techniques for tying these elements to the product because it has been considered that observance of the first principle discussed above (adherence to objective, verified evidence) is more essential than the principle now under discussion (complete tracing of the flow of funds).

Refinement of Financial Accounting Through Cost Accounting

One purpose of cost accounting is the refinement of financial accounting. Has cost accounting developed any fundamental ideas about tracing the flow of funds different or better than the generally accepted principles of accounting based primarily on financial accounting? In tracing funds we believe it sound to attach the dollars expended to the thing or service received in exchange. When the thing is put directly into the product we have no difficulty in believing that the same dollars reside in the product. When the thing or the service is consumed and disappears, we transcribe the dollars to the thing or service which received the benefit of the consumption. In cost accounting this tracing continues until all dollars expended either reside in the product or are recognized as lost.

Cost accounting by its techniques of analyzing fixed and variable costs, of measuring capacity and the extent of its use, of tracing distribution costs, etc., and assisted by the cooperative efforts of material control, planned production, planned selling, and market

analysis, attempts to deal with total costs of product. It can and does report to management on this basis. It may be that by these techniques and by the use of the subdivided accounting entities previously referred to, a substantial portion of the expenditures classified in financial accounting as selling, advertising, administrative, and general expense can be logically tied on to the product or service. It seems certain that period accounting is less impressive to the cost accountant than product accounting. As an example, the cost accountant sees little justification for basing depreciation of machinery on annual accounting periods when the cost of the use of machinery can be measured better in terms of its units of production or the hours of its use in production.

If cost accounting can establish the objectivity of its source data and develop its analytical and statistical techniques in accordance with cost accounting principles which have general acceptance throughout industry, would it be heresy to suggest that something closer to total cost of product than present inventory costs may be matched against revenue for the determination of net income and that such more accurate matching would improve the quality of financial accounting? The objective of financial accounting must always be more accurate financial reporting. Financial accountants would, I am sure, welcome the fullest exposition of the ideas and principles advocated by cost accountants which might have a bearing on generally accepted accounting principles.

This discussion of the third selected principle of generally accepted accounting principles (that accounting, to be adequate, must trace the flow of funds) is summarized as follows:

1. Financial accountants have considered that efforts to tie in selling, advertising, administrative, and general expenses to units of product or service do not meet the tests of objective and verified data.
2. Cost accountants are less impressed than financial accountants with the calendar as a rational basis of accounting for dollar expirations and prefer to tie dollar expirations to products and services; accounting for the service of management is attempting to deal with total costs of products.
3. Cost accounting ideas developed in the service of management should be fully considered in the development of generally accepted principles of financial accounting.

Having compared briefly three of the generally accepted principles of accounting, as developed primarily for the requirements of financial accounting, with the characteristics and requirements of cost accounting, let us consider certain other ideas in cost accounting which might be classified as principles.

THE FRONTIERS IN COST ACCOUNTING

We have discussed two kinds of source data of cost accounting, dollar data received from financial accounting and statistical data received from operating departments, and have emphasized the primary requirement that all source data must be objective and verified. Cost accounting also involves methods of combining dollar data and statistical data and, if cost accounting is to have any greater impact upon financial accounting, these methods must also stand the tests of objectivity and verification.

The Reliability of Standard Costs

It has been stated, with some weight, that the only true costs are standard costs and there is general acceptance of the idea that experienced costs are not factual costs useful to management or costs that should be carried forward in a balance sheet in reporting to the public, if they include the costs of avoidable inefficiencies, errors, and waste. Such lost cost elements should be recognized, treated as expired, and charged off as soon as they occur.

Recognition of such cost elements depend upon the reasonableness and accuracy of the standards established for measurement of performance.

Can standards be determined objectively and verified independently? If they cannot they are a pretty weak rod upon which to lean. The answer depends upon whether management has established a carefully thought out analytical plan of operation. There can be no rigid set of rules promulgated from the outside because management is king within its own realm and the standards must reflect the purposes and organization of the particular management. Leeway must be allowed and credence given to the managerial plan. To admit this does not mean that standards are inherently arbitrary or fictional. If standards are to be given greater weight in financial accounting, however, cost accountants must be able to prove to all comers that cost reports are based on objective source data and that such data and the statistical techniques employed have been critically reviewed.

Cost Determination Techniques

The following are illustrations of the techniques referred to:

1. Tracing benefits from expenditures.
2. Use of arithmetical proportions and averages.
3. Sampling.

Is the procedure of tracing the flow of funds through a business enterprise arbitrary or fictional? If the facts are carefully analyzed, two reasonable men can usually agree upon the best or most useful basis of allocation. Many elements of manufacturing, selling, and administrative expenditures can be identified clearly as to benefits received. There are recognized techniques for this tracing, viz., the time period basis (which is overworked), the location basis (division, building, department, section, cost center, individual machine, sales district, or office unit), the operation basis, the operator basis, the product basis, etc. Ideal tracing is to be limited by the cost of obtaining the refinement, but this too can be objectively determined.

Cost accounting often goes astray in its use of the arithmetic of proportions and averages, e.g., if either a proportion or an average is to be used, careful attention must be given to the comparability of the items included in the numerators and the denominators. They must be such as to warrent the arithmetical application.

All cost accountants should be familiar with the principles of making fair tests and samples. Groups containing diversified items must be narrowed to the extent necessary to permit each group to be treated logically as a unit. This is primarily a matter of the original organization of the cost accounting classification of accounts and subaccounts. Careful consideration should be given to the "mix" of the groups from which samples are taken. It is interesting to note in this connection that it can be demonstrated by mathematical laws of probability that increasing the number of items and samples taken at random beyond a reasonable minimum does not have a corresponding direct increase upon the accuracy of the result of the sampling; in fact the accuracy increases only in proportion to the square root of the number of items in the sample. Some business concerns have established standard sampling procedures, e.g., for one purpose the number of items investigated as a sample is selected so that the mathematical probability of error is 20 per cent or 1 out of 5, whereas for another purpose a sufficient number of items is investigated to reduce the mathematical probability of error to 2 per cent or 1 out of 50.

Wherever statistical techniques are used they must be subjected to critical scrutiny, but when used properly they should be recognized as acceptable procedures in support of the reliability of cost accounting statements as factual data.

Inventory Valuation Basis in Relation to Cost and Control Records

The adjustment writing cost down to the basis of the lower of cost or market is a feature of period accounting, necessary primarily because of the dangers of misleading the readers of financial accounting reports as to the reality of reported profits. This basis for stating inventories has never been defined with a degree of exactitude which satisfies all accountants. The best definitions are still matters of debate. In my personal opinion the generally accepted definition which permits market value based on realization market to be reduced below recoverable cost, in order to provide a normal profit in the succeeding period (whereas without such additional write-down a subnormal profit or none at all would result) introduces an unwarranted transfer of profit between periods, and makes financial reporting less objective and verifiable.

There has long been a fiction (others might call it a convention) that cost marked down to replacement or realization market at December 31 becomes cost on January 1. Cost accountants may recognize the impelling arguments for this idea in financial accounting but may doubt that management is best served for its internal purposes by relieving employees of responsibility for cost elements by a blanket write-off once a year. The cost basis of inventory valuation recognizes losses for spoiled, obsolete, or unmarketable product and such losses should be recognized in the accounts not only at the annual closing of the accounts for financial accounting purposes, but promptly after the dates they become evident. With adequate control of inventories, markdown losses may be recorded in the accounts from day to day. This accomplishes part of the write-down to market obtained in practice, by the use of the lower of cost or market idea, in financial accounting systems not supported by adequate inventory control.

Should cost accounting agree to adjustment of its detailed cost records of materials on hand so that they agree in total with the amount of the inventory valued on the basis of the lower of cost or market for financial accounting purposes? An alternative method is to record the total markdown in the financial accounting records as a valuation reserve to be applied to the cost basis inventory for financial accounting and to continue the cost basis inventory in the cost accounting records.

The use of inventory reserves has, of course, been frowned upon in financial accounting. The underlying reason is the abuse of such reserves in past experience. There is no excuse for a general guess as to an over-all probable amount required to measure the difference between cost and replacement or realization market value of an inventory. However, if the difference is carefully determined on an objective and verified basis, there should be no objection to the treatment of the adjustment as a reserve, continuing the cost information in the accounts, and redetermining the required reserve at the dates when financial accounting reports are to be prepared.

If this reserve is recorded only in the financial accounts, cost reports to management can be presented on a continuous flow basis with recognition of actual losses as they occur from day to day. This procedure eliminates considerable confusion in cost accounting records and increases the utility of cost reports to management.

Depreciation on Original or Replacement Costs?

As years of inflated prices, 1947 and 1948 have seen a resurrection of the old question of whether financial accounting should adopt the idea that in order for management to maintain its capital fund intact, it must include allowances for depreciation in its costs, computed as if its fixed assets had cost present prices. The alternative is, of course, that financial accounting should

recognize only dollar capital accountability. The American Institute of Accountants has held to the idea that accounting is most useful when operated on the basis of dollar capital accountability. The question is much debated at the present time.

The problem is that if prices double and stay at that level, for example, management will not have "depreciation cash" to replace its plant at its original capacity, and will not be able to maintain original capacity unless it retains profits for reinvestment or obtains new capital dollars from its stockholders or the public. Every business entity, of course, rides up and down with the rising and falling tides of the purchasing power of the dollar. The Government, the creditors, and individual stockholders or owners of each business enterprise ride the same tides. Presumably the selling prices, the short-term costs of the product, and the working capital needed to finance current operations ride the tides and respond quickly to changes in prices. Fixed assets, having an average life of perhaps twenty to thirty years, are affected slowly and fixed asset accounts and the current allowances for depreciation included in cost in the determination of net income, recorded on a basis of historical cost, reflect only the historical weighted average of construction prices.

It appears to be an accepted principle of business management that a business should be capable of preserving its own productive capacity rather than merely its dollar capital. This is primarily a question of economics and managerial control which must have the serious consideration of management as part of its plans for pricing the product, for financing operations, and for its relations with labor, creditors, the Government, and the sources of capital. It is extremely important to the system of free enterprise that business should hold intact its physical capital, its capacity to produce. It is important that management obtain sales prices high enough to permit the accumulation of funds for replacement of the productive capacity. This does not mean, however, that the expired value of fixed assets determined as if they had been bought at current replacement prices should be stated as incurred costs in financial statements.

Reflecting Economic Realities

It is certainly proper for management to embellish its financial reports with supplementary data as to the economic problems involved or to establish reserves for the replacement of fixed assets out of earned surplus or undistributed profits, after profits have been stated on the basis of historical cost. Such reserves record the opinion of the management that it is necessary to retain its undistributed income for the purpose of holding its economic capital and record an intention to transfer such reserves to a capital account as and if the reinvestment at higher prices takes place. It is always possible for management to adopt a revised basis of capital accountability by means of a quasireorganization (or a formal reorganization) if it believes that its capitalization has become out of step with economic realities.

Management needs facts, not to provide automatic answers to its problems, but to provide something solid on which it can stand. Cost accountants must provide management with analysis and interpretation of management's plans of operation on the basis of tracing dollars to their benefits, preparing objective standards of measurement, and comparing actual results with those standards. If cost accountants can assemble economic data for management as a supplementary service, well and good, but it should be presented as opinion data with adequate disclosure as to source and it should be presented without confounding and confusing the readers of cost reports. Cost reports should be based on historical cost.

New Problems of Compensation of Corporate Executives

By Charles H. Towns, C.P.A.

Introduction

The income tax problems of corporate executives' compensation are basically the same as other income tax problems. On one side, the Treasury's objectives are to obtain enough revenues to meet expenditures, to collect as much as is practicable of the income taxes which the Congressional statutes require to be paid, and to collect them as efficiently and economically as they can. On the other side, while taxpayers admit that they must pay some amounts of income taxes, their objectives are opposed to those of the Treasury, at least to the extent that they want to pay as little as they can without being subjected to penalties, interest charges, etc. When these conflicts of objectives and interest exist, it is not surprising that such a torrent of rulings, interpretations and decisions pours forth from the Treasury and the Courts that one of the major problems of taxpayers and of those who advise them is to know what they should know about these rulings and decisions.

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This paper was presented by Mr. Towns on October 21, 1948, in the Federal Tax Lecture Series of The New York State Society of Certified Public Accountants.

One group of income tax problems relating to compensation of executives is concerned with determining the taxable income of the executives. In this group we find questions of the time when compensation shall be included, whether certain items (such as stock options received) should be included, the amount to be included and whether amounts received are taxable as compensation or as capital gain. We also have questions of constructive receipt, problems of "compensation for services rendered for a period of thirty-six months or more and back pay" under Section 107 of the Code, problems of the relation of this section to "forgiveness" as it applied to taxes computed for 1942 and 1943, and others which it seems unnecessary to specify here.

The other main group of tax questions relating to compensation of corporate executives is that of deductions for amounts paid by corporations. Some payments have been held excessive and only the part determined not excessive has been held deductible. Some payments of compensation have been disallowed because they were said to be equivalent to dividends. It has been necessary to determine whether amounts were paid as consideration for purchase of assets or as compensation.

Other questions involved have included those as to time when compensation is deductible, whether compensation paid to an officer's widow after the date of his death is deductible, how stock options should be treated, and many related questions.

Certain New Decisions and Problems

I—*Cases and questions relating to inclusion of compensation in the income of executives.*

(a) *Charles Schall and Daisy B. Schall, his wife,* v. *Commissioner*—11 T.C., No. 16.

Dr. Schall was pastor of a church in Pennsylvania for 18 years. Then, due to ill health, he had to retire. The church voted him $2,000 per annum as Pastor Emeritus, with no pastoral authority or duty.

The Tax Court, in a decison promulgated July 30, 1948, held that this amount was taxable compensation. The holding appears to have been based partly upon an assumption that since Dr. Schall's salary had not been increased during the 18 years of his pastorate (although gifts had been made to him) the $2,000 per annum was payment for past services—to make up for inadequate prior salary. Another basis for the decison is that the word "salary" is used in describing the $2,000 per annum, in the authorizing resolution.

If the payment was intended to be a non-taxable gift, a little attention to the latter point when the authorizing resolution was being drafted might have resulted in a less costly decision.

(b) *Hall C. Smith* v. *Commissioner*—11 T.C., No. 25.

The petitioner was president and sole stockholder of a corporation. In 1942 and 1943 he received salaries, a part of which was held to be excessive and not deductible. The corporation was insolvent in 1943 and Mr. Smith had been held liable, as transferee, for its unpaid taxes, to the extent of the excessive amount of salary received.

Mr. Smith filed a claim for refund of the federal income tax he had paid on the part of the compensation held to be excessive. The Tax Court held that such part of the compensation had been received by Mr. Smith in trust for the corporation's creditors and that it was therefore not a part of his taxable income. A stockholder and officer of a solvent corporation could hardly rely upon getting any tax benefit from the line of thought expressed in this decision. On the other hand, he would probably be able to keep what he had received from the corporation, less his income taxes, while Mr. Smith could not.

(c) *Arthur N. Blum* v. *Commissioner*—11 T.C., No. 15.

The taxpayer was employed by a large manufacturer of saws, to perform whatever duties were assigned to him. If he developed saws of a certain type and they were manufactured and sold by the company, he was to receive as a commission a percentage of the amounts collected for the saws. He claimed that the commissions received were the proceeds of sale of patents to the saw manufacturer and taxable as capital gain to the extent that they exceeded his cost. The Commissioner held that they were taxable as ordinary income. The Tax Court held for the Commissioner.

It appears that, for the taxpayer to win, it would have been necessary for him to have foreseen, many years in advance, that it would be advantageous for him to treat the receipts in question as capital gains and to have made a fundamentally different contract with the manufacturer.

(d) *Lewis H. Ross* v. *Commissioner,* CCA (1)—July 13, 1948.

The officer withdrew in 1941, salary earned and accrued on the corporation's books in 1932. He did not in-

clude the amount in computing income tax in either year. Under the complex and special circumstances of the case, the Circuit Court held for the taxpayer and he was not required to pay income tax on the salary. The income was constructively received in 1932 and the Commissioner knew the facts but did not require that tax be computed and paid on it for that year. Since it was income in 1932 it was not subject to 1941 income tax. It was too late to collect the 1932 tax, as such.

Further, under the existing conditions, the Commissioner could not assess and collect a tax under Section 3801.

The outcome of this case no doubt left the taxpayer in a cheerful mood. Other taxpayers are not likely to get much cheer from the decision, however, because it seems unlikely that many others will be able to present the peculiar set of facts necessary to produce the result indicated by this decision.

(e) *James Newton Dean* v. *Commissioner*—10 T.C., 672

The taxpayer was employed under a contract which provided for payment to him of a basic salary and a percentage of the amounts of certain sales. His income taxes were computed on a cash basis. His employer received a ruling in 1943 from the Salary Stabilization Unit, limiting the amount of additional compensation which could be paid to him in 1943 to that which was paid in 1942. This ruling was protested and in April, 1944, another ruling was received which permitted payment of larger amounts in accordance with the employment contract. Amounts to which the taxpayer was entitled were received in 1944. These amounts exceeded 15% of the taxpayer's 1944 gross income. The Tax Court held that the receipts were 1944 income, but that the tax should be computed under Section 107(d) of the Code, which provides for limitation of the tax, under stated conditions, to the amount which would have been payable on the earnings if they had been received in the year or years to which they were attributable.

(f) *A special ruling* is to be found in a letter written by the Acting Commissioner under date of February 6, 1948 and reported by Commerce Clearing House in their 1948 Federal Tax Service, Volume 5, paragraph 6076. This letter reverses the effect of one written earlier. The following, in the final paragraph of the letter of February 6, 1948, gives the essential part of the later ruling:

> "* * * this office now holds that the forgiveness feature of the Current Tax Payment Act of 1943 may be applied in computing the limitation upon the amount of tax attributable to income which is referred to in section 107 of the Code and which is received in 1944, or a subsequent year, even though all or a part of such income was earned in the year 1942 and/or 1943".

The following Tax Court decisions may also be of interest, in this connection:

William F. Knox v. *Commissioner* — 10 T.C., 550 (Promulgated March 30, 1948).

William S. Moorhead v. *Commissioner* (Memorandum Decision, entered March 30, 1948).

Arthur T. Schmidt v. *Commissioner* — 10 T.C., 746 (Promulgated April 30, 1948).

(g) *Interesting questions* regarding income taxes on compensation are sure to arise under the new provisions of Section 12(d) and related changes made in the Code by the Revenue Act of 1948. Here is one to which some consideration has been given. Assume that an executive, whose income taxes were computed on a cash basis, died on July 31, 1948; that prior to the time of his death he had earned commissions of $15,000 which had not been paid, credited or made available to him up to the time of his death; that in 1948, after his death, his estate received cash for the amount of the commissions. Will the benefit of the "splitting of income" provisions be lost and must the entire amount be taxed to the estate?

If the widow is the beneficiary and if the income of the estate must be dis-

tributed or is actually distributed in 1948, the income would not, in effect, be taxed to the estate but to her and if she does not re-marry before the end of 1948, under section 51(b)(3) of the Code it appears that a joint return of her income and of her husband's would be in order. This would make it possible to take advantage of the "income splitting" provisions of Section 12(d) of the Code. In an actual case, of course, many other facts would need to be considered, over and above those mentioned here, before deciding how the tax can and should be computed.

(h) *The effects of income taxes* relating to executives' compensation can be very far-reaching. There has recently been reported a suit by minority stockholders of a corporation against certain directors who were presumably also executives. They had approved waiver of a right to a deduction relating to an employes' stock purchase plan. It is reported that the waiver resulted in tax cost of $535,000 to the corporation and a tax saving of $500,000 to the directors. Whatever may be the merits of the case, it seems clear that it is another indication of the importance and value of studying all aspects of an income tax matter before reaching a decision and taking action.

II—*Regarding deductions of corporations for executives' compensation:*

(a) The most common problem of deductions for executives' compensation, in making tax computations, is that of determining whether or not amounts claimed are reasonable in amount. If the Commissioner determines that the amount of compensation is unreasonably large and then the taxpayer carries the matter to the Tax Court, he has the burden of proving that the Commissioner's determination is erroneous; the Commissioner does not have to prove that it is right, except as it may be necessary for him to offset proof presented by the taxpayer. The particular facts and circumstances in each case are held to be controlling; no formula or general rule has been developed for determining whether or not compensation is reasonable. The corporation may not be allowed a deduction for the compensation held to be excessive, but the executive who receives it will have to pay a tax on it, in most cases. Under these conditions it is easy to see how important it is to set salaries at amounts which are in fact reasonable. Furthermore, from time to time decisions have been rendered against corporate taxpayers, disallowing deductions for compensation of executives, on the ground that the evidence submitted is not sufficient to establish the reasonableness of deductions claimed or to show that the Commissioner was in error in his disallowance. This points up the importance, not only of planning for compensation which is reasonable but also of having records and other evidence available to prove that it is reasonable, if such proof becomes necessary.

Some of the factors which have been held favorable, in recent cases, in determining that compensation was reasonable are outlined below. Conditions opposite to those stated would be unfavorable.

1. Compensation was not at a higher rate than another or others have paid or are willing to pay the executive.
2. Decision as to amount of compensation was based on "arms-length" bargaining.
3. Compensation paid to several executives is not in proportion to their stockholdings.
4. The corporation has paid dividends in or near the year for which compensation is being considered.
5. A balance of net income remains after payment of compensation.
6. Compensation in prior years was less than would have been reasonable.
7. Business was established or developed by executives to whom compensation was paid.
8. Executive has been with the taxpayer for a long period of years.
9. Executive was experienced in the industry or activity to which the services were rendered.
10. Executive has been well educated in subjects tending to fit him to perform

the duties for which compensation was paid.

11. The nature and quality of work done was such as would ordinarily be expected to command relatively high compensation.
12. A large number of hours were devoted to the work each day, week, month or year.
13. Success of the undertaking was due to the abilities and efforts of the executives and not to conditions outside of their control.
14. If increased compensation as compared with prior years is under consideration then it is obviously helpful to show increases in duties, responsibilities, experience, education or effectiveness of services.

The Tax Court has stated that no one factor is to be taken as determinative of the reasonableness of compensation. As a practical matter, however, if the foregoing item 1 can be clearly demonstrated it is very effective in showing that the compenation paid was not excessive. Item 2 can also be a very persuasive point. In August, 1948, the National Industrial Conference Board published booklet No. 32 of its series on "Studies in Business Policy". This publication contains 44 pages of material, principally statistical, on the subject "Executive Compensation in Thirty-Nine Industries." This publication may be helpful, in some cases, in deciding what will be reasonable compensation or in demonstrating that compensation paid has been reasonable.

Following are references to some of the recent Tax Court decisions and memorandum decisions on the subject of deductibility or non-deductibility of compensation of executives, paid or incurred by corporations:

Bergen Fabrics Corp.—Memo (Docket No. 10985, ent'd 4/7/48).

Brooks Equip. & Mfg. Co. — Memo (Docket No. 12981, ent'd 4/13/48).

Cabart Theatres Corp. — Memo (Docket No. 11434, ent'd 6/30/48).

Cletrac (The) Ohio Sales Co. — Memo (Docket No. 14673, ent'd 6/25/48).

Farbro Realty Corp. — Memo (Docket No. 16091, ent'd 6/29/48).

Hemenway-Johnson Furn. Co. — Memo (Docket No. 13648—ent'd 6/23/48).

Hoffman Radio Corp. — Memo (Docket No. 11683—ent'd 6/29/48).

Miles-Conley Co., Inc. (10 T.C., 754—promulgated 4/30/48).

Ornamental Fabricators, Inc. — Memo (Docket No. 15575—ent'd 8/25/48).

Pabst Air Cond'g Corp. — Memo (Docket No. 13635—ent'd 8/20/48).

Wall Products, Inc. — (11 T.C., No. 6, promulgated 7/20/48).

Walmor, Inc. — Memo (Docket No. 15954, ent'd June 18, 1948).

West Dodd L'g Cond'r Corp. — Memo (Docket No. 10357, ent'd 6/23/48).

(b) Another problem of compensation in connection with which there have been several decisions during the past year is that of the time when deduction may be taken by a corporation. This matter is of special importance, under the present Section 24(c) of the Code and the related regulations because if an amount is accrued but is not paid within the required time and is non-deductible under that section in a given year, then even if it is paid later it will not become deductible in either year.

In the case of *Pivaronas Bros. Bakery, Inc.,* Docket No. 13496, a memorandum decision was entered by the Tax Court on August 13, 1948, holding that certain amounts of compensation were not deductible, due to the provisions of Section 24(c), because they were not "includible in the gross income" of the person to whom the payment was to be made, in the taxable years under consideration, and the other bases of denial of deduction by Section 24(c) were present. The amounts had accrued and they had been credited to an accrued salary account. Proof was not furnished, however, which satisfied the Tax Court that the salary was subject to withdrawal by the executive without restriction. Accordingly, the Court concluded that the amounts had not been constructively received. The executive had actually included the amounts in computing gross income in his income

tax returns. However, the standard set by Section 24(c)(2) is based on whether or not the amounts are "includible" (and not on whether or not they are "included"). Accordingly, the fact that they were included gives no benefit to the employing corporation with respect to making the salary an allowable deduction to it. There have been one or more similar decisions prior to the one outlined above.

In the case of *Akron Welding & Spring Co.,* 10 T.C., 715, the Tax Court held that payment of salary by a note of the employing corporation was sufficient to establish payment so that deduction of the salary was not barred by Section 24(c). There have been numerous cases on this subject, the Tax Court has been reversed, to the taxpayers' advantage, and the Tax Court in recent cases, including *Mundet Cork Corp.,* T.C. Memo., Docket 15845, entered June 30, 1948, has seemed to believe that it should render decisions for the taxpayer in such cases. Nevertheless, the Commissioner of Internal Revenue has recently announced nonacquiescence in the *Akron Welding* case. This leaves the matter again in a state of uncertainty. The practical solution seems to be for corporations to make payment in cash or other property, where that can be done.

(c) A special feature of executive compensation arose in *Colonial Amusement Co.* (11 T.C., No. 8), promulgated July 20, 1948. The corporation accrued salaries of executives of $26,500 in 1935 but paid only $11,769.72 in that year. The balance was paid in 1936. The entire $26,500 was claimed as a deduction in the corporation's 1935 return, but $14,730.28 was disallowed for that year and allowed for 1936, upon audit of the returns, because it was found that the books were on a cash basis and this amount had not been paid in 1935.

Then, in connection with 1942 and 1943 excess profits tax computations, the corporation claimed that its deduction of $14,730.28 in 1936 was an abnormal deduction under Section 711(b)(1)(J)(i). The contention was that this item was abnormal in class, because this was the only time when the corporation had been required to pay, in one taxable year, salaries to its officers for services rendered in a prior year.

The Tax Court held that the deduction of $14,730.28 was not an abnormal item under Section 711(b)(1)(J)(i).

This is a decision that may be of interest more because it relates to an unusual claim than because it is likely to have wide application.

The foregoing outlines some of the income tax problems of compensation of corporate executives which have been of special interest during the past year. It has not been practicable, of course, to present in a comparatively short article, all of the related problems which have perplexed taxpayers during the past twelve months. Similarly, it has not been found possible to state methods of preventing or solving all of these tax difficulties of compensation. However, it is hoped that some suggestions of practical value may be found in the material which has been presented.

Tax Saving Effects of the Split Income Provision

By Herman Burstein

This note examines the savings achieved through the "split income provision" of the Revenue Act of 1948. The provision permits the total taxable income of a married couple, regardless of the amount actually earned by each spouse, to be taxed as though each earned exactly half the income. The result in many cases, because of the progressive nature of the income tax schedule, is to bring into effect a lower tax on the total income than if each spouse separately computed tax on what he or she respectively earned.

The first part of this note assumes that one spouse earns no taxable income. Later this assumption is removed.

I

There exists a maximum limit of $24,994.95 to split income saving. This maximum is first reached when taxable income is $400,000 and remains in effect until taxable income exceeds $487,468.55. Above the latter level the saving begins to decline because of the provision in the Revenue Act that limits the tax to 77 percent of taxable income. The saving reaches zero for incomes twice or more the amount of $487,468.55, namely for amounts of $974,937.10 and higher. $487,468.10 is the amount at which the 77 percent limitation begins to take effect for a single person; $974,937.10 for a married couple.

Split income saving as a percentage of taxable income is progressive up to the taxable income level of $120,000, at which point the maximum percentage of 12.102 occurs. Split income saving begins with taxable incomes above $2,000. The percentage of taxable income saved increases at a fairly rapid pace between incomes of $2,000 and $35,000, going from 0 to 11.4 percent. Thereafter the progressive character of the increase is greatly moderated, as may be seen from the fact that taxable income must rise from $35,000 to $120,000 before .7 of a percentage point is added to attain the maximum ratio of taxable income saved. From the $120,000 to the $974,937.10 level, the percentage of taxable income saved declines moderately but steadily from 12.1 percent to zero percent.

Split income saving as a percentage of income tax (before the saving) is progressive up to the taxable income level of $28,000, where the maximum percentage of 29.126 occurs. The percentage of tax saved increases very quickly between taxable incomes of $2,000 and $20,000. After $20,000 it rises much less rapidly. After the $28,000 level the percentage saved decreases slowly and regularly to the zero point at the $974,937.10 level. For taxable incomes up to $5,000, which include about 96 percent of taxpayers, the maximum percentage of tax saved is 9.536. Savings upward of 20 percent obtain for those with taxable incomes of $12,000 to $100,000. Only for taxable incomes above $300,000 does the

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split income saving drop below 10 percent of taxable income.

Table 1 presents the figures upon which the foregoing discussion has been based. The following data are given for selected taxable income levels from \$2,000 to \$947,937.10: (1) amount saved; (2) saving as a percentage of taxable income; (3) saving as a percentage of tax (before the saving).

II

Table 1 and the discussion thus far are based on the premise that one spouse earns all the taxable income. However, it is now necessary to examine what happens when the second spouse earns part of taxable income. This is done in Table 2, which shows for a few selected income levels the percentage of maximum split income saving realized when the second spouse earns 10, 20, 30, or 40 percent of total income. Maximum saving is defined as the amount which obtains when the first spouse earns all of taxable income; this amount is given in Table 1. When the second spouse earns 50 percent of income, the split income saving disappears.

To illustrate the use of Table 2, let us look at total taxable income of \$10,000. Table 1 indicates a split income saving of \$407.20 if the first spouse earns all of taxable income. However, if the second spouse earns 10 percent of total income, that is, \$1,000, split income saving is reduced to 67.29 percent of \$407.20, namely to \$274. If the second spouse earns 20 percent of total taxable income, the split income saving is reduced to 34.58 percent of maximum, that is, of \$407.20.

The rate of disappearance of saving is very rapid when the second spouse earns part of taxable income. For moderate taxable incomes of \$3,000 to \$10,000, only about two-thirds of maximum saving is realized when the second spouse earns as much as 10 percent of total income. The percentage of maximum split income saving realized drops to between one-third and two-fifths when the second spouse earns 20 percent of income, except in the neighborhood of the \$4,000 bracket, where the drop is to only 60 percent. Percentage of saving realized declines to as little as 10 percent when the second spouse earns 30 percent of total income, and to as little as zero percent when the second spouse earns 40 percent.

About the same generalizations may be made for incomes of \$10,000 to \$50,000, except that a more regular pattern is to be observed: Where the second spouse earns 10 percent of taxable income, the saving is about two-thirds of maximum; at 20 percent the saving is about one-third; at 30 percent the saving is about one-sixth; at 40 percent the saving is about 3 or 4 percent of maximum.

Further sets of generalizations may be drawn from the data in Table 2. On the whole, it may be observed that as income rises the percentage of saving realized within a category (percentage of income earned by the second spouse) tends to fall.

TABLE 1

SPLIT INCOME SAVING FOR SELECTED INCOME LEVELS
(ONE SPOUSE HAS NO INCOME)

Taxable Income	Amount Saved	Saving as Percentage of Taxable Income	Saving as Percentage of Tax (Before Saving)
$ 2,000	$ 0.00	0.00%	0.00%
3,000	27.60	0.92	5.25
4,000	55.20	1.38	7.68
5,000	90.40	1.81	9.54
6,000	125.60	2.09	10.67
8,000	266.40	3.33	15.63
10,000	407.20	4.07	17.68
12,000	618.40	5.15	20.81
14,000	847.20	6.05	22.72
16,000	1,146.40	7.17	25.16
18,000	1,428.00	7.93	26.27
20,000	1,762.40	8.81	27.67
25,000	2,589.60	10.36	29.06
28,000	3,064.80	10.95	29.13
30,000	3,328.80	11.10	28.66
35,000	3,988.80	11.40	27.66
40,000	4,613.60	11.53	26.59
45,000	5,185.60	11.52	25.40
50,000	5,757.60	11.52	24.42
55,000	6,382.40	11.60	23.74
60,000	6,954.40	11.59	23.04
65,000	7,632.00	11.74	22.71
70,000	8,204.00	11.72	22.15
75,000	8,908.00	11.88	21.94
80,000	9,471.20	11.84	21.44
85,000	10,131.20	11.92	21.16
90,000	10,738.40	11.93	20.83
95,000	11,398.40	12.00	20.58
100,000	12,058.40	12.06	20.36
110,000	13,290.40	12.08	19.82
120,000	14,522.40	12.10	19.39
130,000	15,490.40	11.92	18.73
140,000	16,524.10	11.80	18.24
150,000	17,428.35	11.62	17.67
160,000	18,422.85	11.51	17.26
170,000	19,153.35	11.27	16.67
180,000	19,883.85	11.05	16.16
190,000	20,350.35	10.71	15.52
200,000	20,816.85	10.41	14.95
225,000	21,768.73	9.68	13.62
250,000	22,720.60	9.09	12.60
275,000	23,641.20	8.60	11.77
300,000	24,092.45	8.03	10.88
350,000	24,543.70	7.01	9.35
400,000	24,994.95	6.25	8.24
450,000	24,994.95	5.55	7.25
487,468.55	24,994.95	5.13	6.66
500,000	24,352.40	4.81	6.33
550,000	21,788.65	3.96	5.15
600,000	19,224.90	3.20	4.16
650,000	16,661.15	2.56	3.33
700,000	14,097.40	2.01	2.62
750,000	11,533.65	1.54	2.00
800,000	8,969.90	1.12	1.46
850,000	6,406.15	0.75	0.98
900,000	3,842.40	0.43	0.55
950,000	1,278.65	0.14	0.18
974,937.10	0.00	0.00	0.00

TABLE 2

SPLIT INCOME SAVING WHERE BOTH SPOUSES EARN TAXABLE INCOME: PERCENT OF MAXIMUM SAVING REALIZED FOR SELECTED INCOME LEVELS

Total Taxable Income	Percent of Maximum Saving Realized Where Second Spouse Earns 10% of Taxable Income	20% of Taxable Income	30% of Taxable Income	40% of Taxable Income
$ 3,000	70.00%	40.00%	10.00%	0.00%
4,000	80.00	60.00	40.00	20.00
5,000	65.27	30.53	15.27	0.00
6,000	70.00	40.00	10.00	0.00
8,000	70.57	41.14	21.14	10.57
10,000	67.29	34.58	17.29	0.00
15,000	64.51	35.31	15.89	3.53
20,000	65.91	37.95	16.98	3.99
30,000	66.62	38.60	17.45	3.70
40,000	64.77	36.24	16.40	4.58
50,000	61.44	31.78	12.82	2.73
60,000	59.98	29.61	11.13	2.28
70,000	59.00	29.61	11.80	3.00
80,000	56.70	28.68	12.95	3.60
100,000	55.61	28.02	12.41	3.07
200,000	52.56	27.28	11.31	2.96
300,000	45.93	20.74	7.24	2.51
400,000	37.99	13.87	5.31	1.44
500,000	30.85	8.58	1.85	0.00

New York State Tax Clinic

Conducted by Benjamin Harrow, C.P.A.

Release of Liens

A real estate corporation had not filed any franchise tax returns for five years and was dissolved by proclamation on December 15, 1936. The corporation had a parcel of real estate and conveyed it to a purchaser. To give a good title to the property it was necessary to submit evidence that there was no lien against the property for franchise taxes. Normally a corporation will submit a receipted bill showing that its franchise taxes have been paid. It is possible also to obtain a release of the lien. The Tax Commission will issue such a release if it feels that the franchise tax is safeguarded.

The Department takes the position that a corporation dissolved by proclamation is not liable for franchise taxes subsequent to the date of dissolution by proclamation, up to January 1, 1948, the effective date of an amendment to Section 191 of Article 9 which became law on March 24, 1947. This amendment provides that a corporation which continues to do business after it has been dissolved is nevertheless subject to a franchise tax. The amendment was passed following the decision of the courts in *Brady-Palmer Printing Co. v. Tax Commission*[1], which held that a corporation was not liable for franchise taxes for the period following its dissolution. Section 182 provides that the owning or holding of property constitutes the carrying on of taxable business.

In the above case the corporation will be required to file returns for the five years preceding its dissolution and also for the year 1947. Upon payment of franchise taxes for those years, including penalties and interest, the lien against the property conveyed will be released.

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Commodity Futures—Business or Investment Income?

Is a gain on the sale of commodity futures to be treated as investment income? If not, what amount would be investment capital? Investment capital means investments in stocks, bonds, and other securities issued by a corporation or by the United States government, by a state or its political subdivision. (Section 208). The Regulations (Article 331) add that other securities do not include corporate obligations such as contracts of sale, etc. A commodity futures contract would thus not be construed as investment capital and, consequently, the gain resulting from the sale would not be investment income.

[1] June 2, 1941; aff'd., July 29, 1942, 289 N. Y. 585.

Combined Return for Business Company and Real Estate Company

May a real estate corporation taxable under Article 9, whose property is not used or occupied by a parent company, taxable under Article 9A, file a combined return if it wishes to do so?

Article 560 of the Regulations states that "a combined return may be required or permitted in any case where substantially all of the capital stock of a real estate corporation is owned or controlled directly or indirectly by a taxpayer," or where substantially all the capital stock of such real estate corporation and the business company is owned or controlled directly or indirectly by the same interests, and any material part of the property of the real estate corporation is used by the business corporation in the conduct of its business.

The consent of the Tax Commission is necessary to the filing of a combined return. If there is no distortion of income because of the ownership of the stock of the real estate company by the business corporation the Tax Commission will not require a combined return. There is no option given to the taxpayer to do so.

Taxation of Life Insurance Proceeds —Payable at Death of the Insured

Amounts received under a life insurance contract paid by reason of the death of the insured are excluded from gross income. (Section 359 (2)(a)). This is similar to the federal rule. Until recently there had been considerable uncertainty as to whether such insurance proceeds were totally exempt if they were paid to a beneficiary in installments. Under such a mehod of payment the beneficiary receives not only the face value of the policy (the principal) but an interest increment. The Commissioner sought to tax the interest increment in each installment. The courts were divided on the issue and some decisions drew a distinction between an option to take installment payments provided by the insured in the policy and an option exercised by the beneficiary. In *Commissioner* v. *Pierce*[2], the Circuit Court of Appeals held that no matter who exercised the option, installment payments were payments paid by reason of the death of the insured and were therefore exempt in their entirety. The Treasury Regulations have since been amended to accord with this decision.

Article 72 of the Regulations was amended on December 17, 1946, to conform to the Federal rule. The pertinent provision reads, "It is immaterial whether the proceeds are received in a single sum or otherwise."

If the insurer holds the proceeds under an agreement to pay interest thereon, the interest payments do represent taxable income.

One exception to the exemption of insurance proceeds is the case where the insured has disposed of his policy for a valuable consideration. In such a case the transferee is in receipt of taxable income when he receives the proceeds. Furthermore, since such proceeds are includible in gross income, the difference between the proceeds and the consideration paid for the policy plus subsequent premiums paid, if any, would be taxed as ordinary income and not capital gain, the same as under the federal rule.

Under the federal law it has been held that where the insured assigns a policy on his own life to his wife for a consideration, and the wife makes an assignment of it to a third party by gift, the proceeds received by the third party upon the death of the insured are taxable to the extent that they exceed the consideration paid by the wife.[3]

It has also been held that the transfer of a life insurance policy to a new corporation in a non-taxable reorganization is a transfer for a valuable consideration and the proceeds received by

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[2] 146 F.(2d) 388 (1944).

[3] *Harper* v. *Commissioner,* 36 BTA 659.

the assignee corporation would be taxable to the extent that they exceed the cash surrender value in the hands of the transferor at the time of the reorganization.[4] Presumably, the state rule would be the same in the above situations.

If the insurance proceeds are paid to a trustee of a life insurance trust, who then distributes the proceeds to beneficiaries of the trust, the latter are likewise exempt from tax on such distributions. Article 72 exempts such proceeds paid "to a beneficiary, directly or in trust."

Taxation of Life Insurance Proceeds —Payable Other than at Death

In the case of an endowment policy that matures during the life time of an insured, the proceeds are subject to income tax. If the proceeds of such a policy were payable to a beneficiary by reason of the death of the insured, the proceeds would be exempt as outlined in the previous discussion. The amount taxable as ordinary income would be the excess of the amount received over the aggregate premiums or consideration paid for the policy.

The Regulations (Article 39) state that the amounts received under such an endowment policy would not be taxed until they exceed the aggregate premiums paid. However, installment payments received under an endowment policy during the life of the insured are treated as annuity payments. These are subject to tax to the extent of 3% of the aggregate premiums or consideration. If the proceeds are left at maturity with the insurance company under an agreement to pay interest, such interest is of course taxable.

It is difficult to reconcile the treatment of installment payments under an endowment contract as annuity payments and the provision in the regulations that amounts received are not to be taxed until they exceed the aggregate premiums paid. This situation came before the Tax Court in the case of *George H. Thornley*.[5] The Court said that an annuity means a payment computed in relation to a life expectancy. That would mean that if an insured elected before maturity to take installment payments, no part of the proceeds would be taxable until they exceeded the consideration. The Treasury has just announced that Section 29.22 (b) (2)-2 is to be amended to provide that installment payments under an annuity or endowment contract would be treated as an annuity only if the amounts are based on a computation with reference to life expectancy and mortality tables.

The Regulations under the Code provide that if the installment option is elected after maturity the insured shall be deemed to have received the proceeds constructively. If the proceeds are payable to a named beneficiary, the latter is taxable and not the insured, and the insured would not be deemed to be in constructive receipt of the proceeds.

Taxation of Annuities

Annuity contracts are quite different from life insurance and endowment contracts, although insurance contracts and annuity contracts are frequently combined. Both insurance contracts and annuity contracts are usually made with an insurance company.

Under federal and state tax law amounts received as an annuity are included in gross income to the extent of three per cent (3%) of the cost of the annuity. The excess of three per cent is treated as a return of the cost of the annuity and is excluded from gross income. When the aggregate exclusions equal the cost, the entire amount received as an annuity is included in gross income and taxed as ordinary income.

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[4] *King Plow Co. v. Commissioner,* 110 F(2d) 649, (CCA-5).

[5] 2 TC 220 (1944).

A retirement annuity contract is one that provides for annual payments by an annuitant until a stipulated age, after which the company agrees to pay the annuitant a specified annuity income during his lifetime. A deferred annuity contract is one that may be purchased for a single premium at least a year before the annuity payments begin. In form they are similar to endowment policies and the principles governing payments under such contracts would be similar to those governing endowment proceeds.

Joint and survivorship annuities contemplate the payment of an annuity for the life of one spouse and, upon the death of that spouse, for payments to the surviving spouse for the latter's life. Under the federal rule, annuity payments to the extent of three per cent of the cost of the annuity are included in gross income of the first spouse and also the surviving spouse until the cost of the annuity has been recovered through the exempt portion of the annuity payments. Thereafter, the entire annuity payment is taxable.

The nature of a joint and survivorship annuity has not yet been clearly defined by the courts. From the insurance standpoint such an annuity is really the combination of two annuities in one contract. The first is an annuity for the life of the husband and the second is an annuity for the wife, to commence upon the death of the husband. It would seem, therefore, that the taxble portion of the annuity payment to the surviving wife should be three per cent of the cost of the annuity contract for her surviving years and not the cost of the annuity contracts for both husband and wife.

Annuities Certain and Refund Annuities

Annuities certain contemplate fixed payments for a definite number of years, without regard to life expectancies. Perhaps the annual payments should be excluded from gross income until the cost of the annuity has been recovered. However, it is more likely that such contracts would be treated as regular annuities and the annual payments taxed to the extent of three per cent of the cost. If the annuitant dies before receiving all the payments, another beneficiary continues to receive the balance of payments. As to the latter, the commuted value of the subsequent installments represents a bequest or devise and this beneficiary receives tax exempt payments to the extent of the commuted value. He would however be taxable on any interest earnings received on the commuted value. A portion of each annual payment would be construed as representing interest income.

The refund annuity is like the joint and survivorship annuity, except that the refund annuity provides for the return of a specified principal sum of money paid for the annuity, whereas the joint survivorship annuity depends upon the lives of the two annuitants. In the refund annuity the second beneficiary receives any remaining balance in a lump sum. Such a payment is a tax exempt bequest.

Combination Insurance—Annuity Contracts

This type of contract gives the insured an annuity for life and provides for a lump sum settlement to a named beneficiary upon death. The death benefit generally represents about 90% of the total premiums paid, while the annuity may equal 3% of the total premiums.

Under the federal rule the Treasury considers the annuity payment as fully taxable interest and does not recognize such payments as annuity payments. In the well known case of *Helvering* v. *Le Gierse*[6] the United States Supreme Court held that for estate tax purposes the death benefits under such a combination contract did not arise out of a

[6] 312 U. S. 531.

life insurance contract. The Treasury Department does not separate the annuity feature of the contract from the insurance feature.

Employees' Pension or Retirement Funds

Contributions to such a fund by an employer do not constitute income to the employee for the year the payment is made by the employer. Contributions made by an employee constitute the cost to him of the purchase of a retirement annuity and when the employee begins receiving annuity payments, three per cent of this cost is includible in his taxable gross income. If the employee makes no contribution to the retirement plan the entire annual payment is taxable income. Amounts deducted from an employee's salary for contribution to a pension fund are, of course, taxable to the employee as salary.

Transfers of Annuities

The transferee is exempt from tax to the extent of the consideration given plus the amount of subsequent premiums. On the annual payments the transferee will be subject to tax on three per cent of his cost and after he has recovered his cost based upon the untaxed portion the entire payment becomes taxable. An annuity would appear to be a transaction entered into for profit. Hence, where an annuitant incurs a loss on the transfer of an annuity or otherwise, the loss would appear to be deductible. It was so held in *Cohan* v. *Commissioner*.[7] In this respect an annuity differs from a life insurance or endowment policy.

Dividends on Life Insurance Policies

These are treated as a return of premium and are not treated as income on an investment. If total dividend payments exceed the aggregate premium there is a resulting gain that is taxable. If dividends are accumulated on a policy and then paid at death together with the face value of the policy, then the entire amount is exempt from tax as proceeds of insurance payable by reason of the death of the insured.

The effect of accumulating dividends on an endowment policy that matures during the insured's life is to reduce the cost of the endowment policy and hence to increase the taxable proceeds at maturity. In the case of annuities, dividends decrease the cost of the annuity and hence the basis of the three per cent calculation is reduced, thus reducing the taxable portion of each payment received. If accumulated dividends are left with the insurer and interest is paid on such accumulations, such interest also is probably to be considered as a reduction of the premium or cost.

Even on paid up policies any dividend paid is not treated as taxable income, but rather as a further reduction of the cost of the policy. The effect of this is to accelerate the time when the entire annual installment is to be treated as income.

Premiums on Life Insurance Policies

Generally premiums are not deductible from gross income since they are considered to be personal expenditures. If the beneficiary of a policy is a charitable corporation and the insured may not change the beneficiary, the premium would be an allowable deduction as a charitable contribution. Furthermore if a policy is irrevocably assigned to a trustee for the benefit of a charitable organization, the cash value of the policy would qualify as a charitable deduction.

In the case of group life insurance policies on the lives of employees where the latter may designate the

[7] 11 BTA 743; aff'd., 39 F (2nd) 540.

beneficiaries, the employer may deduct the premiums paid and the employees are not taxable on the premiums as additional compensation to them. That is not true in the case of premiums on ordinary individual life insurance policies on the lives of employees. In that case the premium paid by the employer is additional compensation to the employee and taxable to him. If the employer is directly or indirectly the beneficiary of the policy, he may not deduct the premiums paid.

A corporation insures the life of one of its important employees, the proceeds being payable to the corporation. The corporation may not deduct the premiums paid. And if one of the large stockholders insured the life of the employee the corporation being the beneficiary, the stockholder could still not take a deduction for the premiums paid. The same result would follow if the beneficiaries of the policy were the stockholders of the company. In the latter case the premiums would be treated as dividends paid to the stockholders.

Interest on Life Insurance Loans

Interest is a deductible expenditure even though it is related to a personal transaction. In the case of interest on policy loans, to be deductible the interest actually must be paid. If the insurance company adds the interest to the loan it is not deductible, even though a new note is signed by the insured. On the cash basis the taxpayer must actually make a cash expenditure for the interest in order to deduct it.

It is now also settled that if insurance premiums are paid in advance covering a period of more than one year and the premiums are deductible as a business expense, only a pro rata portion of the payment will be allowed as a deduction each year. That is true regardless of whether the taxpayer is reporting his income on a cash basis or accrual basis.

Investment Capital

This question has been asked several times. Do investments in mortgages on real property qualify as investment capital under the franchise tax law? The Regulations (Article 331) define investment capital as investments in stocks, bonds, and *other securities* issued by a corporation, by the United States, or by a State or its political subdivision. The Regulations say further that other securities refer to those of a like nature, as stocks and bonds which are customarily sold in the open market or on a recognized exchange. Other securities are those issued by a corporation for the purpose of financing the enterprise. They would include debentures, notes, and certificates of indebtedness which have the essential characteristics of bonds. The Regulations say further that other securities "do not include corporate obligations not commonly known as securities, such as chattel mortgages, contracts of sale, purchase money obligations, etc." Also, investment capital does not include investments in securities of an individual, partnership or trust.

It is the opinion of this editor that real estate mortgages are not intended to be included as investment capital. The Regulations do not specifically exclude such mortgages from the concept of other securities, except to the extent that purchase money obligations are definitely excluded and, likewise, non-corporate obligations. Real estate mortgages may, of course, be sold in the open market, but they are not generally issued by a corporation for the purpose of financing the enterprise in the sense that stock is issued to raise capital.

The Unincorporated Business Tax

A member asks whether a salesman who is employed by a foreign corporation on a commission basis and who also sells a kindred line on his own account is subject to the Unincorporated

Business Tax and the extent to which he would be so taxed. The salesman devotes a minor portion of his time to his own business. Actually it represents about 20% of his gross income, the balance of his income being derived from the commissions he earns as employee.

Section 386 of the Law states that an individual shall not be deemed to be engaged in an unincorporated business subject to the tax with respect to compensation for services rendered by him as an employee. Article 5 of the Official Questions and Answers discusses the question of whether an agent is an employee or an independent agent. "If the activities of an agent are independent . . . both as to the operation of his office or place of business and the method to be used by him in securing business, he is considered to be carrying on an unincorporated business even though under the terms of his contract he is an employee." "If, however, the agent is an employee performing services in an office maintained entirely by the employer and if the agent is accountable to the employer both as to the method in which his affairs are carried on and the results obtained therefrom, it will ordinarily be held that he is not engaged in an unincorporated business . . ."

Sale of Personal Residence

Under federal law the sale of a personal residence at a profit is taxed as a capital gain. The basis for determining the gain is cost and this is not adjusted for depreciation since no depreciation on a personal residence is currently allowed as a deduction from gross income. A sale at a loss is not allowed as a deduction since there is no specific provision in the code that permits such a deduction. The acquisition of a personal residence is not a transaction entered into for profit. Hence a loss is not deductible.

The treatment under state law is different. A profit results in a taxable gain and a loss results in a capital loss that may be used as an offset against capital gains. The basis for determining either gain or loss is cost adjusted for depreciation for the entire time held by the taxpayer, even though such depreciation is not an allowable deduction currently from gross income.

Change of Accounting Period by Spouses

To take advantage of the income splitting feature of the federal income tax law the tax period of both spouses must be the same. Many taxpayers have therefore sought the approval of the Commissioner of Internal Revenue for a change in their accounting period. Under date of August 17, 1948, the State Tax Commission issued a ruling that an application for a similar change under the income tax law and the unincorporated business tax law (Articles 16 and 16A) will be approved upon proper application. The Commission should receive the application at least 30 days before the return is due on the old basis and 30 days before the close of the proposed taxable year. A copy of the Federal consent should accompany the application.

A change in accounting period usually results in a short intervening period for which a return must be filed. This return must be placed on an annual basis.

Accounting at the S.E.C.

Conducted by William W. Werntz

Recent addresses

The Chief Accountant, Mr. King, recently addressed the New Jersey and Wisconsin Societies on the subject of "Generally Accepted Accounting Principles." His paper reviews various "authoritative sources" starting with the old Federal Trade Commission bulletin of 1917 and touches on the major pronouncements of the Institute down to and including the current accounting and auditing bulletins. He also mentions the statements issued by the American Accounting Association and Sanders, Hatfield and Moore's "A Statement of Accounting Principles." He concludes:

"It would appear that our body of generally accepted accounting principles is not to be found in one place; that while there are some principles which are so generally accepted as to constitute rules, there are many others concerning which serious differences of opinion exist within the profession. I should like to suggest that the profession increase its efforts to resolve these differences.

"Much could be accomplished in this respect, I think, if the Institute would adopt the policy of issuing its Accounting Research Bulletins so worded as to establish the considered views of its membership as definite statements of principles—rules, if you please. Optional treatments and qualifying comment should be avoided and it should be made quite clear that deviation by clients from these established principles would result either in an exception in your certificate or the refusal to certify in cases where the effect of the non-accepted practice would, in your opinion, make the statements misleading.

"Also, I think, the Institute might well consider the publication of a statement of accounting principles as comprehensive and as forthright as that of the Association. In connection with the compilation of such a statement it would seem highly desirable that the Institute and the Association get together and arrive at a single solution for those matters upon which they now appear to differ. Personally I should like to see a joint statement which would leave no doubt as to what is meant when the term 'generally accepted accounting principles' is used.

"I have referred to a report of a 'Special Committee on Development of Accounting Principles' which was adopted by the membership of the Institute in 1934. In this report it was stated that:

"'Under the act creating the securities and exchange commission as passed at the last session of congress, that commission has wide powers to prescribe methods of accounting and your committee believes that a close cooperation with the commission is desirable and should permit of the formulation of accounting rules or principles in accordance with the policy which has been outlined. Obviously, the Institute desires to keep in close touch with the work of the commission for the purpose, first, of assuring that the methods prescribed by that body conform to the best accounting opinion and shall not be prejudicial to the welfare of the profession or the community; and, secondly, to enable it to bring rulings made by the commission to the attention of members of the Institute and to secure their cooperation in all measures designed for the protection of investors and benefit of the community.'

"The Commission has cooperated with

William W. Werntz, formerly Chief Accountant of the S.E.C., is now associated with Touche, Niven, Bailey & Smart, C. P.A's.

Mr. Werntz is a graduate of Yale University and of Yale Law School, and is a member of the Connecticut Bar. He was formerly an instructor of accounting at Yale University and Yale Law School. He was also an accounting consultant to the O.P.A. and the Treasury Department.

Mr. Werntz is the author of numerous articles which have appeared in technical accounting publications. He is Vice-President of the American Accounting Association.

the accounting profession in its attempts to formulate accounting rules or principles. Although we do have 'wide powers to prescribe methods of accounting,' very few of these powers have been exercised and the occasions upon which there have been ultimate disagreements between the profession and the Commission with respect to accounting matters have been rare indeed. And you may be sure that the Commission will continue to work with the profession to the end that in the not too distant future there may be developed a comprehensive and authoritative statement of generally accepted accounting principles."

Andrew Barr, Assistant Chief Accountant, recently participated in a symposium sponsored by the Accounting Section of the Milk Industry Foundation on the subject "Are Current Depreciation Reserves Adequate?" His paper reviews the policies followed by companies in the milk industry which file with S.E.C., and cites with approval the position recently taken by the Committee on Accounting Procedure of the American Institute. The following excerpts are of interest:

"The position of advocates of adhering to cost as a basis for depreciation is that depreciation accounting is not intended to provide a replacement reserve. In a business operating consistently at a profit, funds equal to the depreciation charges do become available. The disposition of these funds and the providing of additional amounts, if these are inadequate for current replacement, is believed to be a financial problem of management and not a problem of accounting. The sample of the milk industry represented by registrants with the Commission, as I have said, covers a substantial portion of the investment in the industry. In my review of the notes to the financial statements for the past year, I found only one direct recognition of the current discussion over depreciation policies. In a note to the profit and loss statement referring to depreciation, the registrant said, 'Such depreciation has been accounted on the basis of original cost without recognition of prospective replacement cost indicated by the present increased general price level.' In notes describing the carrying value of the property, plant and equipment, this company and three others point out that the amounts shown do not purport to represent present day realizable values or current replacement cost. One of these companies and one other revealed a special earmarking of plant replacement funds: in one case this is described as 'unsegregated bank funds' but displayed in the fixed asset section of the balance sheet; in the other, the item is presented on the balance sheet between the sections for 'investments' and for 'property, plant and equipment.' This is described as 'Special Fund: United States Government securities to be applied in meeting capital expenditures in excess of normal additions—as authorized by board of directors.' There is a schedule reference and a parenthetical notation that 'Unfilled orders and commitments approximate the amount of the fund.' The fund was used in the succeeding year. Property schedules in this case revealed additions to property, plant and equipment approximately ten percent in excess of the sum of the current year's provision for depreciation, proceeds of sales of fixed assets and the special fund. The amount involved represented a ten percent increase in gross plant.

"This last example may be extended to the eleven companies registered with the S.E.C. For the year 1947 cost of additions to property, plant and equipment, exclusive of land, totalled $83,000,000 of which only a minor amount was identified as being in connection with new businesses acquired. Depreciation charges for the year totalled $27,000,000 and proceeds of sales of property, plant and equipment, exclusive of land, appeared to be $10,000,000 or a total of funds available from these sources of $37,000,000, leaving $46,000,000 to come from other sources. Net income for the eleven companies for the same period was $57,000,000 but dividends paid during the year amounted to $30,000,000 leaving $27,000,000 for re-investment in the business. $19,000,000 therefore came from other sources to balance the plant expansion for the year. As we have seen in one case, funds had been set aside in a special fund for this purpose. How much of the $83,000,000 is replacement and how much represents expansion, my figures fail to reveal. As I have said, only a small amount is identified in the reports as acquisitions of new businesses. In the schedules furnished by one of the smaller companies in the group, a footnote to the additions total (about 20 percent increase in the year) states that these 'although extensive, do not indicate any significant or unusual change in the general character or location of the business, but rather a general expansion of present facilities.'

"That a substantial portion of the amounts reported as additions represent replacements of retired facilities at prices substantially higher than original costs of items of approximately identical service value must be admitted."

* * * * *

"The material I have discussed brings me back to the basic question, 'Are Current Depreciation Reserves Adequate?' Adequate for what purpose? In the generally accepted accounting sense of measuring the 'hole' in the assets, I think I have shown that management and their independent accountants answer 'yes' to the original question. If the question was intended to imply that depreciation is a function of replacement, I doubt if anyone here can answer it with confidence, even though at present price levels substantial inadequacy may be indicated. Who knows today when replacement will take place and at what cost in relation to recorded costs of items replaced? If present price levels are employed as a measure, who can say now how a provision for depreciation accumulated at varying rates will compare with ultimate replacement cost? This financial problem is most pressing in industries employing large amounts of long lived assets which must be replaced only at irregular and long intervals of time. The situation is clearly less acute in a business with a minor investment in fixed assets or in short lived assets which must be replaced on a fairly regular program. Although 1947 annual reports to stockholders of three of the largest companies in the milk industry discuss the impact of inflationary forces on commodity prices, costs of doing business and profits, none of them discusses the depreciation problem. The nearest approach is in the report of the largest of these companies in which contemplated expenditures for replacements and additions to property, plant and equipment are mentioned. It was expected in this case that funds needed for the purpose would be provided from cash resources, depreciation, and future earnings. The report states that the extent to which the program would be continued depended upon the economic situation and cash resources as they develop. The other two reports associate profits for the year after dividends, depreciation for the year, and capital expenditures without raising the price index or replacement aspect of the problem. One of the reports is notable for the thorough and forthright manner in which the president defends the company against the popular charge that current profits are inexcusably high or excessive and that insufficient dividends are paid. Part of his answer bears on our subject. He says that earnings in excess of dividends paid have gone into the increase in net current assets or to the increase of capital assets necessary to keep production equal to demand for their product. 'Making expenditures from earnings,' he says, 'to enable us to carry on such operations as will meet the larger demand will, in the course of time inevitably justify itself to the end of still higher annual earnings and a higher rate of dividends.' These examples and others that could be cited from stockholders reports from other branches of industry, indicate that adequate supplementary disclosure can be made of the influence of changing price levels on the financial management of corporations without tampering with depreciation accounting on a cost basis in accordance with present day generally accepted principles of accounting."

New appointment

James P. Goode, an attorney with S.E.C. since 1935, has been appointed Assistant Director of the Division of Corporation Finance.

Amendment to Regulation S-X

The Commission has adopted a new Article 5A applicable to promotional mining companies. The new rules, which appeared as Accounting Series Release No. 66, were discussed in an earlier issue.

Mailing lists

At intervals S.E.C. seeks to bring its release mailing lists up to date by asking those interested to sign cards requesting their names to be continued on the lists indicated. Unless such cards are filled out and returned, subscribers are dropped from the lists. The most recent mailing of this sort is of special interest since a number of changes have been made in the nature and groupings of materials making up a "classification of releases" for purposes of the mailing lists. In filling out the cards, care should be taken to check the accompanying descriptive material to assure receipt of desired data. To accountants, the "accounting material" and the "rules" classifications will prove most useful; however, several of the statistical series bulletins provide excellent reference and general data.

PROFESSIONAL COMMENT

By EMANUEL SAXE, C.P.A.

Toward a Synthesis of Accounting Doctrine

Gordon W. Stead, a graduate student in economics at the University of California in Berkeley, has prepared a most interesting and valuable paper on this subject for the October, 1948, issue of The Accounting Review. It is offered by him as a tentative attempt to synthesize previously expressed views and to make more orderly the present quest for principles.

1. *Principles:* Adopting the meaning of an invariable cohesive force for the concept of principles, Mr. Stead includes thereunder the basic all-pervading principle of *integrity* in the independent exercise of judgment. This he subdivides into the two explanatory principles of *clarity* and *stability* of decision.

2. *Canons:* To achieve these ends, certain canons (goals derived from the principles) are postulated: To achieve clarity, there must be both *literal accuracy* and *correct impression.* To attain stability of decision, there must be both *consistency* and *comparability.*

3. *Standards:* Standards are viewed as measures against which conduct must be squared. Thus, literal accuracy is achieved by (a) *objectivity* in such forms as the use of the dollar, either stabililized or not, as the unit of account; the use of realization or production as the criterion of revenue, etc.; (b) adherence to the principles and rules of proper classification (*taxonomy*); and (c) compliance with the standard of *legality,* to insure that the content of classifications would have the same meaning at law as in accounting.

Correct impression depends upon the standard of (a) the *going-concern* approach; (b) *a full disclosure* of all items (*completeness*) of a material nature (*materiality*) giving due consideration to the *flexibility* needed to avoid "indiscriminate adherence to prescribed rules using classifications and procedures unsuited to an unusual business;" and (c) the accrual basis of accounting with the careful *matching* of revenues and costs.

It is intended that the canon of consistency previously indicated be achieved by the application of standards with respect to *terminology* and *method* at a time, while comparability over a period of time would depend upon the convention of the regular *accounting period* and relative rigidity of the *form* of financial statements.

4. *Rules:* The rules of accounting, according to Mr. Stead, comprise the large *body of definitions and procedures* which are detailed mandates for particular cases.

The author points out that the value of this system lies in the fact that it is anchored very securely at the top (principles) and that any change which may be contemplated over a period of time is likely to occur in increasing degree in the successively lower orders, and may be checked constantly against the superstructure for initial clarity and ultimate flexibility.

Standard Manufacturing Costs for Pricing and Budgeting

This is the latest report (No. 14) in the research series of the N.A.C.A. covering the uses of standard costs, and is published as Section Three of the October 1, 1948, Bulletin. The

field study of 72 companies, upon which the earlier reports in the series were based, also provides the factual basis for this report.

The study notes that the use of standard costs in pricing and budgeting is particularly apropos since they are predetermined costs based upon "careful study of what can be accomplished with the production facilities available" and may be "readily adjusted to reflect anticipated changes in prices of material and labor, production methods, or volume." This is highly desirable since price and budget decisions always precede actual operations.

The study reports that standard costs are generally utilized for pricing purposes when they are available. Also, that the expected actual performance type of standard cost is employed for the purpose, but that an average provision for unavoidable variances is generally reflected therein, where necessary to convert other types of standard cost thereto.

The report indicates that only 39 of the 72 reporting companies have budgets based on standard costs for planning and coordinating their future activities. Since budgets are intended to be forecasts of the expected actual performance experience, any standard costs used in building up budgetary cost figures must likewise reflect any expected variances from standard.

How Much Testing?

William D. Cranstoun reexamines the basic auditing technique of test-checking, *inter alia,* in the lead article of the October, 1948, issue of The Journal of Accountancy. In this connection, he attempts to answer such questions as: Do auditors test-check more extensively than necessary? Can statistical sampling methods help establish the amount of testing necessary, and thus make testing more reliable with less work? Reference is also made made to an unpublished paper on the application of sequential analysis to determining sample sizes in auditing, written by John Neter, of Columbia University, which the Journal hopes to publish as soon as the problem of terminology can be resolved for the lay reader. We look forward to this sequel with much interest.

Problems in Reporting Corporate Income

In a very stimulating paper in the Harvard Business Review for September, 1948, George D. Bailey, the immediate past president of the American Institute of Accountants, examines the problems involved in adequate corporate reporting and sets forth the basic accounting requirements for the annual measurement of corporate progress.

After indicating the importance of adequate corporate reporting, he notes that though the quantity of reporting may presently be considered satisfactory, the quality is not. In addition to reporting surveys disclosing a surprisingly large disbelief in financial reports, Mr. Bailey points out the existence of serious difficulties in the accounting basis thereof. The general nature of profits, the relation of prices to profits, the effect of volume on profits, the difference between earnings and dividend distributions, etc., are not generally understood, he says. Though corporate reports have taken on a "new look", it is his opinion that nothing material has been added for the benefit of the serious analyst. In fact, he believes that most of these reports are pitched at too low a level of reader intelligence.

To remedy this situation, Mr. Bailey proposes, first, the further education in accounting of the report-reading public, so that they may better understand and use these reports. Then, he advocates better corporate income and financial reporting in the press and business magazines. He suggests that the collegiate schools of business administration take the lead in providing

the necessary adult education facilities for the attainment of these goals.

Next considered are the problems of the proper presentation of corporate earnings. Mr. Bailey traces the changes in accounting outlook with respect thereto that occurred during the periods when the stockholder was successively regarded (1) as a permanent investor, (2) as if his ownership might be temporary and (3) as only one of many various groups interested in the results of corporate activity.

The content of financial statements is next discussed: The quantitative viewpoint, i.e., the stewardship report of "how much", and the qualitative aspect, viz., the comparative ascertainment of "how good", receive attention and Mr. Bailey concludes that, in the latter connection accountants are currently doing an excellent job in sharpening the presentation of income.

Mr. Bailey notes fairly general agreement on the extent of the information which it is desirable to report. However, he discusses briefly two recent developments in income reporting: (1) the so-called division of expenses and costs by natural classifications, which he looks upon with favor, and (2) the single-step form of income reporting, from which he perceives little benefit to be derived. A strong plea is also made by the author to accounting teachers for leadership in the development and use of reporting terms that will convey the same meaning to both the layman and the expert reader.

While the foregoing problems of corporate reporting are vital, they yield in importance to the annual accounting measurement of operating results. Says Mr. Bailey:

> "In order to reach the goal of a sharp measurement of progress year by year and company by company, there are three basic accounting requirements: (1) There must be a minimum of arbitrary shifting of items of income or expense from one year to another. (2) There must be a minimum of extraneous or arbitrary items that distort the showing of the results of operation. And (3) earnings must be clearly etched against the backdrop of the economic conditions of the year."

The effect of the Accounting Research Bulletins in establishing standards and sharpening the concepts of net earnings is discussed generally and followed by specific consideration of Bulletins 23 (income taxes), 26 (the use of special war reserves), 28 (general purpose contingency reserves), 29 (inventory pricing), and 31 (inventory reserves, for future losses not inherent in the inventories on hand).

Mr. Bailey concludes this half of his presentation with a brief consideration of the effect of the changing value of the dollar upon income determination, particularly with respect to inventories and fixed assets. The entire problem of income concepts, with implications for presentation of earnings is scheduled for discussion in the second and concluding article, which is slated to appear in the November, 1948, issue of the Business Review.

COMMITTEE ACTIVITIES

TECHNICAL MEETING
on
NEW YORK STATE PERSONAL AND UNINCORPORATED BUSINESS TAX AND FRANCHISE TAX ON REAL ESTATE CORPORATIONS

Because of the many favorable comments received by the Committee, following its technical meetings last year, it has arranged similar meetings to be held this year, the first scheduled for December 7, 1948.

The Committee, in its last meeting, eliminated the conventional reading of prepared papers and presented, instead, a series of questions gathered from the experience of its committeemen. Following the submission of the questions, the answers were presented, many of which evoked animated discussion.

The questions to be discussed at the meeting on December 7th cover the salient features of the New York State Income and Unincorporated Business Tax and the Franchise Tax on Real Estate Corporations. You are urged not only to attend the meeting, but to participate actively in the discussion on the answers and to submit other questions.

COMMITTEE ON STATE TAXATION

FRANK E. KNOPF, *Chairman*
Subcommittee on Special Meetings

I. *By Harold E. Bischoff, C.P.A.*

1. What is the optional deduction and how does it operate?
2. Does the taxpayer have an option to change from the optional deduction to specific deductions after the due date of the return?
3. Is it advantageous for a non-resident to claim the optional deduction?
4. Does the optional deduction cover only such items as interest on indebtedness, taxes on real property, other taxes and other deductions?
5. John Doe has gross income of $14,500 and specific deductions of $100, and Mary Doe, his wife, has gross income of $2,000 and specific deductions of $700 for the year 1948. How should they file New York State tax returns?
6. Roy Clark, a salesman, employed on a commission basis, incurred unreimbursed expenses as follows:

Traveling expenses while away from home	$500
Entertainment of customers...	300
Total	$800

On his federal return, the taxpayer deducted $500 for traveling expenses and also claimed the optional standard deduction. How should the items be treated in his New York State return?

II. *By J. B. C. Woods, C.P.A.*

Facts: After payment of liabilities and taxes, a New York estate consists of shares in a family business corporation, retained under terms of the will and subject to a life-interest of the widow, who is also the executrix and a resident of New York.

During one fiscal year of the estate, there were no dividends received on the shares held. There was a charge against income, however, consisting of interest on a deficiency of a gift tax, apportioned as follows:

(a) Charged to corpus: Interest to date of death.

(b) Charged to income: Interest from date of death to end of prior fiscal year, when income from dividends exceeded the interest charge.

(c) Charged to corpus: Interest from beginning of current fiscal year to date of payment.

This method of apportionment is advised by attorneys and appears to follow the rule

in *Matter of Harjes*, 170 Misc. 431, as discussed in Dodge and Sullivan, *Estate Administration and Accounting*, p. 450.

Questions:

1. What treatment, for tax purposes, should be accorded to the debit balance in income for the current fiscal year?
2. Should the widow-executrix-life-tenant repay to the estate the excessive income previously distributed to her and take the deduction on her personal income tax return for the year of payment?
3. Should she allow the debit balance to stand until future dividends offset it, and take the deduction in the year of offset?
4. Or, without repaying the estate, and without knowing whether there will be future dividends to offset the debit balance, should she take the deduction on her return for the current year?
5. Should the executrix-life-tenant ignore the debit balance in so far as her own income tax return is concerned and so far as reimbursement of the estate is concerned? In that event, if surcharged by the surrogate, would the amount charged to her be deductible when paid or settled by offset against future income?

III. *By Robert I. Edelson, C.P.A.*

You have assembled the required data necessary for the preparation of the income tax returns for Mr. & Mrs. Taxpayer for the year 1948. Compare the treatment of the following for New York State and Federal Income Tax purposes:

1. Taxpayers were married on February 14, 1948.
2. Medical expenses aggregating $6,000, the greater portion of which was expended by Mr. Taxpayer on behalf of his dependent parents.
3. Life insurance premiums in the sum of $500.
4. Bond premium in the amount of $350 paid in connection with the purchase, in 1948, of $10,000 United States, 2¼% Treasury Bonds issued in 1943, due 1963. Interest received thereon amounted to $112.50.
5. Interest on City of New York bonds in the amount of $750.
6. Federal excise taxes (non-business) in the sum of $125.
7. Child born December 15, 1948.
8. Commission received in the amount of $10,000 on the sale of a factory site. Services rendered in connection therewith began 42 months prior and ended with the consummation of the sale in 1948.
9. New York State income tax paid in 1948 for the year 1947, $850.

IV. *By Ralph G. Ledley, C.P.A.*

You are preparing a New York State Personal Income Tax return. Schedule D, of Form 1040, for the same taxpayer indicates:

(a) A long-term loss on stock of the ABC Corporation—The purchase date of the ABC stock shows as 1944.

(b) No transaction in the stock of the PDQ Corporation. This year's 1040 shows no dividends from the PDQ Corporation, but an examination of last year's return shows dividends from the PDQ Corporation.

(c) No real estate transactions. You also gather by examination of addresses on the taxpayer's return that he has moved during the year and his return for 1948 indicates a lesser real estate tax and mortgage interest deduction than for 1947.

Discuss the application of the above facts to the New York State Income Tax return.

V. *By Nathaniel Field, C.P.A.*

An optometrist operates seven stores. Three stores are located in New York, two in Connecticut, and two in California.

1. What portion of the income would be subject to the unincorporated business tax?
2. Is the income from states, other than New York State, to be included as income subject to Unincorporated Business Tax?
3. What is the allocation formula and what factors are used in its computation?

VI. *By Stanley B. Tunick, C.P.A.*

1. What can a taxpayer-corporation do when it receives an assessment notice from the Department of Taxation and Finance because the assessed value of its real estate is in excess of the book value or the original purchase price?
2. Many real estate corporations have small capitalizations and finance themselves with loans from stockholders which enable them to acquire property. Is there anything which may be done to avoid the tax of 2% on the allocated portion of interest paid on such loans?

CORRESPONDENCE

To the Editor of *The New York Certified Public Accountant:*

In an article on Fringe Labor Costs in the Apparel Industries, appearing in the November issue of *The New York Certified Public Accountant,* such charges were properly pointed out as hidden sources of additional expense which, in many cases, have turned large profits into small ones and gains into losses.

In publishing this article, a worthwhile service has been performed for members of the Society and for many other accountants who have clients in the needle trades in the city. However, it is important that a correction of the rates that must be figured currently should be reported to the profession. After December 26, 1947, the rates stated for the men's and boys' clothing industry with regard to work made for the manufacturer by contractors should be as follows:

	% on Gross Price	% on Payroll
For Social Security and Federal and State Unemployment Insurance Taxes	3.45%	4.0%
For Amalgamated Insurance and Retirement Fund	3.45%	5.0%*
For N. Y. Joint Board Vacation and Holiday Fund	6.05%	7.7%
Total...........	12.95%†	16.7%

* Cost of living bonus of 25¢ an hour is exempt.
† Includes .45% for agency administration expense.

The article stated that 11.30% was the total rate on the gross price. The correct rate on gross price charged by the contractor to the manufacturer is 12.95% or 16.7% on labor. The increase was due to provision having been made for a second week paid vacation. There is also a 5% charge on wages of temporary cutters for vacation purposes.

Very truly yours,
SAMUEL S. RESS

New York, N. Y.

AN ADIRONDACK VIEW

WHEN the pile of unread business, tax, and accounting magazines gets so tall that we are obliged to have two piles; when election bets have all been paid and the country has been saved once again (or has been headed for certain ruin); when clients ask about bonuses once more; when we have lost count of the errors we have made this year; when batches of tax blanks arrive from the collector's office; sure, then its time to wish everybody a Merry Christmas and hope that all the people in our one large world have a better New Year than they had an old one.

LEONARD HOUGHTON, C.P.A.
of the Adirondack "Chapter"

OFFICIAL DECISIONS *and* RELEASES

AMERICAN ACCOUNTING ASSOCIATION

ACCOUNTING CONCEPTS AND STANDARDS UNDERLYING CORPORATE FINANCIAL STATEMENTS

1948 Revision

Prefatory Note

In June, 1936, the executive committee of the American Accounting Association issued a tentative statement of accounting principles relating to the financial reports of business corporations. This was followed five years later by a revision entitled "Accounting Principles Underlying Corporate Financial Statements." In this third statement the committee reaffirms and restates the following preliminary considerations expressed in the 1941 statement:

(a) The basic objective has been to stimulate the continued study and discussion of accounting standards and their periodic restatement, thereby assisting in the orderly development of accounting concepts and their wider acceptance both among accountants and among others in any way influenced by or interested in the findings of accountants.[1]

(b) So many decisions are dependent on interpretations of corporate reports that uniform, objective, and well-defined standards have become a requisite for the use of the reports by persons having an interest in an individual enterprise or in the broader problems relating to the national economy.

(c) Because basic accounting concepts and standards remain relatively undisturbed even during periods of economic change, restatements will involve primarily changes in emphasis.

(d) Although a comprehensive understanding of the financial position and operating activities of a corporation is derived only in part from financial statements, it should nevertheless be possible for a person moderately experienced in business and finance to obtain from such statements basic information on which he may rely with confidence.

(e) In the application of standards individual differences in industries or in enterprises within an industry may require that allowance be made for well-established practices, but the standards here recommended are believed to be capable of general application. Any deviation therefrom should be carefully weighed and, if made, disclosed both qualitatively and quantitatively in the financial statements.

The acceptance by any business organization of the concepts and standards presented here should be viewed not as a submission to arbitrary rules and restraints but as providing an opportunity for interpretation and comparison by means of the common language of accounting.

Assets

The assets or economic resources of an enterprise are its rights in property, both tangible and intangible. The most commonly useful financial statements report the origin and disposition of the assets of an enterprise in terms of costs established and recorded at the time the assets are acquired. The importance of costs as a record of the accountability of an enterprise for its resources makes it essential that their determination be based on available objective evidence. When an asset is *purchased* such evidence is found in the cash outlay, in the fair market value of any noncash consideration, or, in the absence of these measures of cost, in the fair market value of the asset acquired. The measure of cost for an asset received through a *revenue* transaction is fair market value, ordinarily indicated by the established selling price of the goods or services sold. Where an asset is acquired from investors or donors its cost for accounting purposes is fair market value at the time of acquisition.

(1) The cost of a group of assets acquired for a lump sum should be allocated to property units, tangible or intangible, after careful consideration of the nature and condition of each unit, and its intended use and prospective earning power or value in exchange.

(2) If an asset has use or exchange value for a limited period, whether resulting from operations or other events, its cost must be reasonably and systematically assigned to expense or transferred to other assets. The portion of recorded cost to be reported in the balance sheet is the amount assignable to future periods. Where an asset or asset group

[1] Although seldom given express recognition, accounting concepts are embodied in a framework of underlying conditions and assumptions, such as (a) a business entity with an income objective, (b) a continuity of operations as a going concern, (c) the accrual basis of accounting, (d) the need for periodic reporting, and (e) the preparation, from underlying data, of statements embodying the point of view of stockholders.

will be continued in use this amount is the portion of cost recoverable through the remaining useful services the asset is expected to yield. For a fixed asset held for sale the balance-sheet amount is that portion of cost not in excess of the expected net proceeds. A decline in the cost of replacement or reproduction is not conclusive evidence that a portion of unassigned cost cannot be recovered.

(3) There should be no departure from the cost basis to reflect the assets of an enterprise at amounts higher than unassigned cost. Continuous replacements of assets, frequently of a type different from those replaced, and the practical difficulty of measuring replacement value, emphasize the need for a historical record in terms of the consistent, objective basis of cost.[2]

(4) Adherence to the cost basis of accounting requires that there should be no suppression or unwarranted assignment to expense of the costs of existing assets.

Income

The income of an enterprise is the increase in its net assets (assets less liabilities) measured by the excess of revenue over expense. The income of a corporation is not affected by the issuance, acquisition, or retirement of the corporation's own capital shares, adjustments of stockholders' interests, or dividend distributions by the corporation.[3]

Revenue

Revenue is a generic term for (a) the amount of assets received or liabilities liquidated in the sale of the products or services of an enterprise, (b) the gain from sales or exchanges of assets other than stock in trade, and (c) the gain from advantageous settlements of liabilities. Revenue does not arise from a gift.

Revenue is recognized upon the transfer of an asset, the performance of a service, or the use of a resource of the enterprise by another party, accompanied by a concurrent acquisition of an asset or a reduction of a liability.

(1) When the consideration received from a customer is an asset other than cash, the fair market value of the asset is ordinarily indicated by the established selling price of the goods or services sold.

(2) Revenue from interest, rent, royalties and similar contracts should be recognized on an accrual basis in accordance with the conditions of the contract.

(3) The usual criteria for the recognition of revenue are subject to modification where there is an extended period of collection or where related expense of substantial amount is to be incurred after the date of sale.

(4) The appreciation or enhancement of asset values resulting from increased market prices is not recognized as revenue prior to sale.

Expense

Expense is the cost of assets or portions thereof deducted from revenue in the measurement of income. These deductions arise through a current expenditure of cash, a total or partial expiration of asset cost, or the incurrence of a liability. Expense consists of operating costs—deductions that have a traceable association with the production of revenue, and losses—deductions that have no such association.

(1) Expense is given recognition in the period in which there is (a) a direct identification or association with the revenue of the period, as in the case of merchandise delivered to customers; (b) an indirect association with the revenue of the period, as in the case of office salaries or rent; or (c) a measurable expiration of asset costs even though not associated with the production of revenue for the current period, as in the case of losses from flood or fire. The revenue deductions of a period include all costs not previously deducted from revenue and not applicable to future periods.

(2) Expense not subject to precise measurement should be based on estimates of a definitive and consistent character and should be in reasonable conformity with policies generally established within the industry or trade.

(3) The cost of an intangible asset which has a limited-term significance should be assigned to expense by systematic timely charges.

(4) For purposes of determining the expense of a period, it is acceptable to assume a flow of the cost of inventoriable items, for example, "first in, first out." The residual cost should be carried forward in the balance sheet for assignment in future periods except when it is evident that the cost of an item of inventory cannot be recovered, whether from damage, deterioration, obsolescence, style change, over-supply, reduction

[2] Readers of financial statements may be aided in their interpretations by considering the effect of fluctuations in the purchasing power of money. A marked, permanent change in price levels might impair the usefulness of statements reporting asset cost; however, price changes during recent years do not afford sufficient justification for a departure from cost. Accounting concepts and standards appropriate for the reflection of a drastic and permanent change in prices would need to be developed in the event of such a change.

[3] It is recognized, however, that claims or obligations which have arisen from revenue or expense transactions are occasionally settled by the acquisition or issuance of the corporation's own capital stock; e.g., shares may be issued in connection with employment contracts.

in price levels, or other cause. In such event the inventory item should be stated at the estimated amount of sales proceeds less direct expense of completion and disposal. This concept of residual cost may be applied to inventory items, a group of inventory items, or to total inventory. The method of inventory costing should be consistent from period to period and should conform reasonably with practices established within the industry or trade.

(5) An assignment of all or a portion of the cost of an asset to expense, made in good faith after considered judgment and after competent review, in accordance with the accepted accounting concepts and standards of the time, is not subject to reversal in a later period. Errors of a mechanical and nonjudgment nature should be corrected in the period of their discovery.

(6) The creation of or addition to a reserve by a charge against revenue, except in recognition of expense, defers the recognition of income and impairs the significance of the financial statements.

Liabilities and Stockholders' Interest

In a corporation, there are two classes of equities: liabilities and stockholders' interest. They are given accounting recognition at the time assets or services are received or obligations are incurred by the corporation.

Liabilities

Liabilities are claims of creditors against the enterprise, arising out of past activities, that are to be satisfied by the disbursement or utilization of corporate resources. They are measured by cash received, by the established price of noncash assets or services received, or by estimates of a definitive character when the amount owing cannot be measured more precisely.

(1) Any difference between the amount payable when a liability is settled and the amount of the cash or its equivalent received when the liability is incurred should be accumulated or amortized systematically during the period the obligation is outstanding.

(2) When a liability is liquidated, any difference between the amount of assets disbursed and the amount of the obligation as then reflected in the accounts is revenue or expense of the period of liquidation.[4]

Stockholders' Interest

Stockholders' interest is the investment of the owners in the enterprise, consisting of paid-in capital and retained income.

(1) Paid-in capital is measured by the cash, or the fair market value of other assets or services, contributed by stockholders or by persons acting in a capacity other than that of stockholders or creditors, or by the amount of liabilities discharged upon the transfer of an equity from a creditor to a stockholder status. Paid-in capital may be reduced by the redemption or other reduction of outstanding shares, payments of liquidating dividends, or adjustments effected by a corporate reorganization. The reduction of paid-in capital upon the contraction of outstanding shares may not exceed the prorata portion of paid-in capital applicable to the number of shares contracted.

(2) Retained income is the amount of income since the formation or a reorganization of the enterprise less the amount distributed to stockholders. Distributions include dividends and the excess of the amount of assets disbursed in the reacquisition of shares of capital stock over the prorata portion of paid-in capital applicable to such shares. The distinction between paid-in capital and retained income should be permanent. Where retained income has been designated as paid-in capital by means of stock dividends, recapitalizations, or by other customary corporate action the amount so designated should be indicated in the balance sheet.

Financial Statements

Financial statements require not only the application of generally recognized accounting concepts but also adequate presentation and disclosure. Standards for statement presentation include the following:

(1) Assets should be classified in such a manner as will facilitate the accounting for their utilization and the preparation and interpretation of financial statements.

(2) When a separate account (e.g., a depreciation reserve) is used to show the portion of an asset cost assigned to expense, the account should be deducted from the related asset account in the balance sheet.

(3) Assets and liabilities should not be offset unless required by law or contract.

(4) The method of inventory costing should be revealed in the balance sheet.

(5) In exhibiting a long-term liability disclosure should be made of the maturity amount and other significant characteristics of the obligation.

(6) Conditions limiting the disposition of retained income are preferably disclosed by parenthetical comment or footnote. A reserve required by law or contract should be created from retained income and returned undiminished to retained income when the need for it has passed. The determination of income or of the amount of net income carried to retained income should not be

[4] The conditions which permit a discharge of liability at substantially less than the amount reflected in the accounts may be indicative of previously unrecognized or contingent losses.

affected by the creation or dispostion of such reserves.

(7) An outlay by a corporation for shares of its own stock should be treated as a reduction of paid-in capital up to the prorata amount represented by the acquired shares, whether or not such shares are reissuable. If the outlay for the reacquired shares exceeds the prorata reduction of paid-in capital, the excess should be treated as a distribution of retained income. The reissue of acquired shares should be accounted for in the same manner as an original issue of corporate shares.

(8) When values of assets other than costs applicable to future periods are supported by substantial objective evidence, and are materially higher than the cost applicable to future periods such data may be essential in interpreting the economic position of the enterprise. Such information, adequately described as to nature and source, may be shown parenthetically, by footnote, in a supplementary schedule.

(9) The income of an accounting period should be reported in a statement providing an exhibit of all revenue and expense (including losses) given accounting recognition during that period. This practice assures that the income statements for a period of years will disclose completely the entire income history of that period.

(10) The income statement should be arranged to report consistently and in reasonable detail the particulars of revenue and the expense pertaining to the operations of the current period, measured as accurately as is possible at the time the statement is prepared and also any items of revenue or expense not associated with the operations of the current period. Such arrangement of data in a single statement discloses both the earning performance and the entire income history of the enterprise during a given period.

(11) The income statement should reveal the amount of cost assigned to expense by reason of any reduction of an inventory to its recoverable cost.

(12) The effect on income taxes of an unusual item of revenue or expense should be disclosed whenever the effect is material. Similarly, disclosure should also be made of material tax consequences resulting from differences in financial and tax accounting. Such disclosures should not be made by the adjustment of the "provision for taxes" reported in the income statement; this caption should be used for the actual taxes paid or estimated to be payable.

(13) A change in paid-in capital and retained income such as one resulting from the issuance, acquisition, conversion or exchange of capital stock, and from stock dividends, should be disclosed in the financial statements of the period in which the change occurs. Distributions to stockholders and preferences attaching to the ownership of particular classes of shares or capital stock should also be disclosed.

(14) The balance sheet should contain no special section for reserves. Each reserve should be identified as (a) a subdivision of retained income, (b) an asset or liability valuation account, or (c) a liability, and the position of the reserve in the balance sheet established accordingly.

Concluding Comment

If accounting standards are to merit acceptance, financial statements in which they are incorporated must supply dependable information for the formulation of judgments. These judgments made in an economic setting subject to important changes can be relied upon only if such standards are adhered to consistently. Changes in accounting policy should be limited to those that will lead to improved standards.

Accounting for the business activities of modern corporations will continue to offer many problems. As business structure becomes increasingly complex, the special and often diverse interests of investors, management, labor, and government will place increasing demands upon accounting and accountants. The application of accounting concepts and standards in the solution of these problems requires on the part of accountants a high degree of integrity, competence, and social responsibility.

* * *

This statement is issued by the Executive Committee of the American Accounting Association in June, 1948. The preliminary draft of the statement was prepared by a special committee appointed in 1946. The members of this special committee were:

Herbert E. Miller, Chairman
Hermann C. Miller (ex officio)
Paul J. Graber
Thomas W. Leland
James R. McCoy
Hale L. Newcomer

Acknowledgment is made of the valuable suggestions received from many members of the American Accounting Association who reviewed the preliminary draft.

Executive Committee, 1948

Thomas W. Leland, *President*
Victor Z. Brink
Clete F. Chizek
Robert L. Dixon
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Paul J. Graber
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ACCOUNTING RESEARCH BULLETINS

Issued by the

COMMITTEE ON ACCOUNTING PROCEDURE,
AMERICAN INSTITUTE OF ACCOUNTANTS
13 East 41st Street, New York 17, N. Y.

No. 34 October, 1948

Recommendation of Committee on Terminology

Use of Term "Reserve"

FOREWORD

The members of the committee on accounting procedure have approved as an objective the recommendation of the committee on terminology made herein with respect to the use of the term "reserve" in accounting, and have authorized its publication. The statements herein contained, however, are not to be regarded as formal pronouncements of the committee on accounting procedure.

Use of the Term "Reserve"

The term *reserve* is used in accounting in a variety of different and somewhat conflicting senses. As a result clarity of thought and accuracy of expression are impaired and an adequate understanding of financial statements on the part of users is made more difficult than is necessary. In addition the variations in balance-sheet classification and presentation of the so-called reserves contribute to the confusion and make comparisons difficult. It is suggested that the current uses of the term may be reviewed and that recommendations may be made as to acceptable definition and to limitations on usage which will serve to make the financial statements more readily understood.

In dealing with financial matters the term *reserve* is commonly used to describe specific assets which are held or retained for a specific purpose. This is the sense in which the term is employed, for instance, in our banking system, which derives its name from the fact that member banks are required to maintain deposits with the central or *reserve* banks. The term is also used to indicate such assets as oil and gas properties which are held for future development. These usages present no problem in accounting where the assets in question are described according to their nature or referred to as *funds* or *deposits* for specific purposes.

In current accounting practice the term *reserve* is used in four senses, as follows:

1. The term is used to describe (a) a deduction which is made from the face amount of an asset in order to arrive at the amount which it is expected will be realized, as in the case of a reserve for uncollectible accounts, or (b) a deduction which is made from the cost or carrying value of an asset, representing the portion of the cost which has been amortized or allocated to income, in order to arrive at the amount properly chargeable to future operations, as in the case of a reserve for depreciation. In this sense reserves are customarily referred to as valuation reserves, and are usually deducted in the *asset* section of the balance-sheet.

2. The term is used to indicate (a) an estimate of an admitted liability of uncertain amount, as in the case of a reserve for damages, (b) an approximation of the probable amount of a disputed claim, as in the case of a reserve for additional taxes, or (c) an estimate of a liability or loss which is sufficiently likely to occur to require recognition, as in the case of a reserve for self-insurance. These reserves are included in the *liability* section of the balance-sheet, in a section immediately below the ordinary liabilities, or in the *proprietary* section. In the insurance field the term is used in this sense as referring to the portion of the total assets derived from premiums which is required to meet future payments under policies.

3. The term is sometimes used, although not in accordance with the best practice as generally recognized, to indicate a variety of charges set forth in the income statement, including estimated losses as a result of uncollectible accounts and other causes, depreciation, depletion, amortization, probable losses, specific contingencies, and similar items. It is to be noted here that the term refers to the charge by means of which a reserve (in the credit sense) is created.

4. The term is used to indicate that an undivided or unidentified portion of the net assets, in stated amount, is being held or retained for a special purpose, as in the case of a reserve (a) for betterments or plant extensions, or (b) for excess cost of replacement of property, or (c) for possible future inventory losses, or (d) for general contingencies. In this sense a reserve is frequently referred to as an appropriation of retained earnings.

The dictionaries define the term *reserve* generally and in substance in its etymological

sense, as something held or retained for a purpose, frequently for emergencies. It is apparent therefore that the broad usage referred to, in the second paragraph of this memorandum, is one which clearly reflects the general understanding of the term, i.e., specific assets held or retained for some purpose. It is also apparent, however, that the occasions for usage in this sense are distinctly limited, and that where specified assets are segregated and held for some purpose they may be described for accounting purposes by the use of such terms as *fund, deposit, temporary investments,* etc. While the general characterization of these items as reserves is acceptable usage, it is not involved in the problem of definition within the field of accounting.

The first accounting usage of the term set forth above seems clearly contrary to the commonly accepted meaning of the term. A so-called reserve for bad debts or for depreciation does not in itself involve a retention or holding of assets, identified or otherwise, for any purpose. Its function is rather to indicate a diminution or decrease in an asset due to a specified cause; the use of the so-called reserve in this area is essentially a part of a process of measurement. In the recent amendment of the British Companies Act the British accountants appear to have been troubled by the various uses of the term *reserve* and as a result of their recommendations it is now provided that the so-called reserve of this type shall be described as a *provision.* It may well be doubted whether this is an improvement, because any provision must of necessity and in the final analysis be made by the allocation or segregation of assets. While it seems clearly advisable to drop the term *reserve* in this area, it should be replaced by terms which indicate the measurement process, i.e., such terms as "less estimated uncollectibles," "less estimated losses in collection," "less amortization to date," etc.

The second of the four accounting usages set forth above is also contrary to the generally accepted meaning of the term. It may be argued, of course, that the statement of any liability in the balance-sheet is an indication that a portion of the assets will be required for its discharge. In this sense the statement may be regarded as a provision or reserve. It is clearly preferable, however, to regard the statement as indicating the obligation itself which is a deduction necessary to arrive at proprietary investment or net assets. The items in this area described as reserves might better be designated in some such way as "estimated liabilities" or "liabilities of estimated amount."

The third of the four usages set forth above involves different considerations since it is a matter of the income statement rather than the balance-sheet. In a sense a charge of this nature in the income statement, e.g., a charge for depreciation, is a "reserve" in so far as it indicates that cash or other assets received by way of revenues is, to the extent indicated, to be used or devoted to a special purpose. It seems clear, however, that the basic purpose in the making of these charges is one of income measurement and that the designation of such charges as costs, expenses or losses, i.e., elements in the measurement of income, is clearly more understandable than the designation of *reserves.* The description of these charges as *reserves* or *provisions* suggests not only that the function of depreciation accounting is one of replacement, but in addition leads to the suggestion that the provision be based upon estimated future cost. It seems desirable accordingly that the use of the term *reserve* in the income statement be discontinued.

The generally accepted meaning of the term *reserve* corresponds fairly closely to the last of the four usages set forth above, i.e., the indication of an amount of unidentified or unsegregated assets held or retained for a specific purpose. While retention of assets for a variety of purposes is an important phase of corporate management and finance, the retention does not ordinarily involve a segregation. It is suggested that this meaning may well be adopted as the primary significance of the term in accounting and that other uses of the term be discontinued. It is interesting to note that in the 1947 revision of the British Companies Act, the British accountants succeeded in securing a limitation of the term to this area.

To summarize, it is recommended that the use of the term *reserve* in accounting be limited to the last of the four senses set forth above, i.e., to indicate that an undivided portion of the assets is being held or retained for general or specific purposes and that the use of the term in the balance-sheet, in describing deductions from assets or provisions for particular liabilities and in the income statement be discontinued.

COMMITTEE ON TERMINOLOGY

JAMES L. DOHR, *Chairman*
WILLIAM H. BELL
ALVIN R. JENNINGS

ACCOUNTING RESEARCH BULLETINS

Issued by the

COMMITTEE ON ACCOUNTING PROCEDURE,
AMERICAN INSTITUTE OF ACCOUNTANTS
13 East 41st Street, New York 17, N. Y.

No. 35 October, 1948

Presentation of Income and Earned Surplus

1. In Accounting Research Bulletins Nos. 28, 31, 32, and 33, two alternative methods of displaying items excluded from the determination of net income are indicated as being acceptable. Under the first of these methods, the excluded items are displayed in the surplus statement; under the second they are shown in the income statement after the amount designated as net income. Since the issuance of those bulletins, charges and credits displayed in accordance with the second method have been included in many income statements in a manner and with wording which has occasioned misconceptions as to whether the earnings for the period were the amounts captioned as net income or were the final and more prominent amounts shown on the income statements after the deduction or addition of such charges and credits.

2. The committee believes the possibility of misconception in this respect will be minimized by the adoption of the first method in all cases. Accordingly it recommends that the net income for the period be shown henceforth without deductions or additions of items which are properly excluded from the determination of net income. These items consist primarily of charges and credits with respect to (a) general purpose contingency reserves, discussed in Accounting Research Bulletin No. 28, (b) inventory reserves, discussed in Accounting Research Bulletin No. 31, (c) extraordinary items, which, if included, would impair the significance of net income, discussed in Accounting Research Bulletin No. 32, and (d) excessive costs of fixed assets and annual appropriations in contemplation of replacement of productive facilities at higher price levels, discussed in Accounting Research Bulletin No. 33.

3. The committee's recommendation is not intended to preclude or discourage the use of the combined statement of income and earned surplus recommended in Accounting Research Bulletin No. 8, provided the figure of net income is followed immediately by the surplus balance at the beginning of the period; nor is it intended to preclude the use of a separate statement showing the disposition of net income, if practicable. The committee is also of the opinion that deduction of the single item of dividends from net income on the income statement would not be subject to misconception.

The statement entitled "Presentation of Income and Earned Surplus" was adopted by the assenting votes of nineteen members of the committee, of whom four, Messrs. Duncombe, McDevitt, Stans, and Paton, assented with qualification. Two members, Messrs. Bell and Lindquist, dissented.

Messrs. Duncombe, McDevitt, and Stans assent to the bulletin but dissent from the requirement that charges and credits of the type referred to in clause (c) of paragraph 2 must appear only in the surplus account. They believe that charges and credits which would be excluded from the determination of net income under the criteria in Bulletin 32 should be permitted to appear ". . . at the bottom of the income statement immediately following the amount of net income . . . [including] them in the determination of the amount carried to surplus," in accordance with paragraph 12 of that bulletin. They also believe that the portions of this present bulletin which are inconsistent therewith should be changed accordingly. Mr. Paton assents to the Bulletin but does not agree with the implication that it is improper to charge depreciation to revenues on the basis of replacement cost, as found in the reference to Bulletin 33.

Mr. Bell dissents because he does not "believe that the developments of the last few months are sufficiently important to cause the committee to change its previously well-considered utterances on the subject." He states that, in assenting to Bulletin 32, he considered that the principal consideration was adequate disclosure, and objects to this bulletin because he believes it substitutes rigidity for reasonable flexibility.

Mr. Lindquist dissents from clauses (b), (c), and (d) of paragraph 2. He joins Messrs. Duncombe, McDevitt, and Stans in their objection to clause (c). He believes that permission to display on the income statement appropriations of earnings such as those contemplated in clauses (b) and (d) should not be denied since there is ample protection in adequate disclosure and proper captions.

NOTES

1. Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee and the research department. Except in

cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached. (See Report of Committee on Accounting Procedure to Council, dated September 18, 1939.)

2. Recommendations of the committee are not intended to be retroactive, nor applicable to immaterial items. (See Bulletin No. 1, page 3.)

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. (See Bulletin No. 1, page 3.)

Committee on Accounting Procedure (1947-1948)

Samuel J. Broad, *Chairman*
John N. Aitken
William H. Bell
Homer L. Dalton
Thomas M. Dickerson
James L. Dohr
Fred J. Duncombe
J. P. Friedman
Anson Herrick
Thomas G. Higgins
David Himmelblau
John B. Inglis
Paul K. Knight
John A. Lindquist
Edward J. McDevitt
William A. Paton
Maurice E. Peloubet
Walter L. Schaffer
Maurice H. Stans
Virgil S. Tilly
C. Oliver Wellington

Carman G. Blough
Director of Research

* * *

STATE OF NEW JERSEY DEPARTMENT OF BANKING AND INSURANCE

Bureau of Banking

Banks

Statutory Approval, or Order, Number 7

October 18, 1948

Examination of Banks Under Direction of Board of Directors

To Banks:

Pursuant to the authority granted by subsection A of section 253, Chapter 67, Laws of 1948, I, John J. Dickerson, do hereby issue the following regulations relating to examinations required to be made under the direction of the board of directors:

1. The public accountant or other approved and qualified person examining for the board of directors shall confirm with demand depositors and borrowers the correctness of a portion of the deposits due to them, and debts owed to the bank on loans and discounts, including mortgage loans. Such confirmations shall be in writing and be forwarded to at least five percent of the total number of persons having such demand deposits, and to at least ten percent of the persons indebted to the bank by reason of loans and discounts, including mortgage loans; provided, however, that the commissioner may excuse a bank from compliance with the foregoing procedure if it furnishes the Department with satisfactory proof that its own auditors, as part of their internal audits, forward confirmations to the bank's depositors and debtors at least to the extent prescribed in this regulation. Installment loans, such as F.H.A. No. 1, G.I. business loans, consumer credit loans, and other loans less than $1,000, may be excluded from the confirmation, and, if so, the number so borrowing may be eliminated from the total persons owing bank for loans and discounts, including mortgage loans, before computing the number of loans required to be confirmed.
2. The public accountant or other approved person shall, as part of such examination, comment on the sufficiency of the internal controls, offering any suggestions which he believes will strenghten such controls.

(Signed) John J. Dickerson
Commissioner of Banking and Insurance.

The New York Certified Public Accountant

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